UPSTREAM TAKEOVERS

A CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

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April 2009

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INTRODUCTION

The Takeovers Panel has decided to explore ways of better dealing with the Code implications of upstream takeovers, that is, where a takeover, in New Zealand or overseas, results in an upstream acquirer controlling voting rights in a New Zealand Code company because the upstream target holds or controls voting rights in that Code company. The Panel wishes to adopt a clear and transparent policy on upstream acquisitions to provide certainty to the market and to assist the efficiency of market transactions.

The issue of upstream takeovers was highlighted recently in relation to BG Group plc's proposed upstream takeover in Australia of Origin Energy Limited, which had a majority shareholding in Contact Energy Limited, a New Zealand Code company.

This paper identifies the implications which arise under the Code for takeover bids for "upstream" entities which hold or control shares in a New Zealand Code company. Upstream entities that hold or control shares in a New Zealand Code company may be effectively "takeover proof" because of the requirements of the Code. The Paper discusses the Panel's approach in granting exemptions from the Code in respect of these transactions, including the problems that the Panel has faced. It discusses and compares how other jurisdictions deal with upstream takeovers and then sets out a range of potential options for addressing the problems.

Request for comments on this paper

The Panel invites submissions on the issues raised in this paper and the options identified for addressing the issues. A questionnaire is provided at the end of this paper.

The closing date for submissions is **12 June 2009**.

Submissions should be sent to the Takeovers Panel for the attention of Jennifer Fawcett –

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Any submissions received are subject to the Official Information Act 1982. The Panel may make submissions available upon request under that Act. If any submitter wishes any information in a submission to be withheld, the submission should contain an appropriate request (together with a clear identification of the relevant information and the reasons for the request). Any such request will be considered in accordance with the Official Information Act 1982.

BACKGROUND

1. An acquisition of a body corporate may not only result in the acquirer becoming the holder or controller of voting rights in the target company but also in the acquirer's indirect acquisition of control of voting rights of other entities downstream of the target company.[1] This occurs when the upstream company holds or controls voting rights in the downstream company. For example, the downstream company may be a partially or wholly owned subsidiary of the upstream target. The upstream target and/or the downstream company may be a listed or unlisted body corporate under New Zealand law or under a foreign jurisdiction.

2. The acquisition of control of a downstream entity may be incidental to the acquirer's purpose to acquire the upstream target. However, the acquisition of an upstream entity can also be effected for the purpose of indirectly acquiring the downstream entity.

3. Regardless of the acquirer's purpose, if the downstream entity is a Code company for the purposes of the New Zealand Takeovers Code (the "Code"), an acquisition upstream of the Code company may trigger the Code, whether the acquirer or the upstream target is incorporated in New Zealand or a foreign jurisdiction.

IDENTIFICATION OF THE PROBLEM

Status quo

4. Control is defined in the Code as "having, directly or indirectly, effective control" of voting rights.[2]

5. Rule 6 of the Code ("the fundamental rule") prevents any person (together with their associates) with less than 20% of the voting rights in a Code company from increasing their holding or controlling of voting rights in a Code company to more than 20%, unless they use one of the mechanisms in rule 7 of the Code. Rule 7 sets out the exceptions to the fundamental rule.

6. In an upstream acquisition, if the target upstream entity is a Code company, one of the exceptions to the fundamental rule must be utilised in respect of that acquisition. Whether or not the upstream target is a Code company, if that upstream acquisition results in the acquirer becoming the effective controller of more than 20% of the voting rights of a downstream entity that is a Code company, a rule 7 mechanism must be utilised in respect of the downstream indirect acquisition.

7. The relevant rule 7 mechanisms for an upstream acquisition resulting in the indirect acquisition of control of more than 20% of a Code company would require the upstream acquirer to make a takeover offer for the downstream Code company, under rule 7(a) of the Code. Alternatively, the upstream acquirer could obtain the approval

[1] For simplicity we tend to use the term "company" in relation to the entities that could be the targets of an acquisition. It is acknowledged that such entities may be a variety of types of bodies corporate.

[2] Interpretation in rule 3(1) of the Code.

of the downstream Code company's shareholders for the acquisition of the upstream target, under rule 7(c) of the Code.

8. The exceptions to the fundamental rule reflect the underlying principle of the Code that where there is a change of control of a Code company the shareholders of the Code company either get the opportunity to participate in that change of control by receiving a takeover offer or they have the right to approve the outcome, being the sale of a Code-relevant share parcel, through a shareholder vote.

9. If the upstream acquirer made a takeover offer for the downstream Code company, it could do so contemporaneously with, or in advance of, its acquisition of the upstream target, with appropriate conditions to ensure that it did not gain control of the upstream target, and, therefore, of the upstream target's stake in the downstream Code company, unless the takeover offer for the downstream Code company succeeded.

10. Alternatively, the upstream acquirer could seek the approval of the downstream Code company's shareholders under rule 7(c) of the Code for its acquisition of the upstream target.

11. Under rule 17 of the Code neither the acquirer nor the disposers, nor any of their associates, could vote on the rule 7(c) resolution. The upstream target, if it were a majority shareholder of the downstream Code company, could pass or defeat the resolution on its own. It would, however, be prohibited from voting on the resolution if it were an associate of the acquirer.

12. The use of the past tense in rule 7(c) of the Code indicates that the approval of the downstream Code company's shareholders would need to be obtained in advance of gaining control of the upstream target.

Exemptions from the fundamental rule

13. The Panel has granted a number of exemptions from the fundamental rule, pursuant to section 45 of the Takeovers Act 1993, to upstream acquirers in respect of those acquirers becoming the controllers of voting rights in a downstream Code company as a result of the upstream acquisition. The Panel, in deciding whether to grant these exemptions, has focused on whether the purpose of the upstream acquisition was to acquire the downstream Code company. These exemptions are discussed below.

Takeovers Code (Canadian National Railway Company) Exemption Notice 2001

14. In 2001, a wholly-owned subsidiary of Canadian National Railway Company ("Canadian National") merged with Wisconsin Central Transportation Corporation ("Wisconsin Central") which owned indirectly 24% of Tranz Rail Holdings Limited ("Tranz Rail"), a Code company, representing 3.65% of Wisconsin Central's assets. The acquisition would result in Canadian National obtaining Wisconsin's 24% shareholding in Tranz Rail.

15. The Panel granted an exemption from rule 6(1) of the Code for Canadian National and its wholly owned subsidiaries in respect of any increase in their voting control in Tranz Rail as a result of the merger.

16. The Panel considered that the exemption was appropriate because the increase in the percentage of voting rights controlled by Canadian National was incidental to a significant merger transaction between Wisconsin and Canadian National, which itself was directed to operational rail network issues and not the control of the voting rights in Tranz Rail (the assets of which were small in relation to the assets of Wisconsin and Canadian National).

17. The exemption was considered to be consistent with the objectives of the Code because the increase in the percentage of the voting rights in Tranz Rail by Canadian National, then controlled by Wisconsin, was a consequence of the merger transaction between Wisconsin and Canadian National, which did not have the purpose of effecting that increase in the percentage of voting rights.

Takeovers Code (Newmont Mining Corporation) Exemption Notice 2002

18. In 2002, a wholly-owned subsidiary of Newmont Mining Corporation ("Newmont"), a company incorporated in the United States, made a takeover bid for the Australian company Normandy Mining Ltd ("Normandy") which held, through a subsidiary, more than 50.1% of Otter Gold Mines Limited ("Otter"), a Code company, representing 0.35% of Normandy's assets.

19. The Panel granted an exemption from rule 6(1) of the Code for Newmont, and its wholly-owned subsidiaries, in respect of any increase in their voting control in Otter as a result of their acquisition of shares in Normandy.

20. The Panel considered that the exemption was appropriate because any acquisition by Newmont of control of voting rights in Otter would be incidental to Newmont's bid to acquire control of Normandy under Australian law.

21. The Panel considered that the exemption was consistent with the objectives of the Code because any acquisition by Newmont of control of voting rights in Otter would be as a consequence of its bid for control of Normandy, which was not undertaken for the purpose of gaining control of voting rights in Otter (a bid for Otter by Normandy's subsidiary valued Otter at less than 1% of Newmont's valuation of Normandy).

Takeovers Code (A.B.C. Learning Centres Limited) Exemption Notice 2004

22. In 2004, the Australian incorporated A.B.C. Learning Centres Limited ("A.B.C.") and its wholly-owned subsidiaries were granted an exemption in respect of any increase in their voting control in Kidicorp Group Limited ("Kidicorp"), a New Zealand Code company, as a result of a merger between A.B.C. and either or both of Child Care Centres Australia Limited ("Child Care Centres") and Peppercorn Management Group Limited ("Peppercorn"), both incorporated in Australia.

23. The Panel granted an exemption from rule 6(1) of the Code for A.B.C. and its wholly-owned subsidiaries in respect of any increase in their voting control in Kidicorp, as a result of the proposed merger.

24. The Panel considered that the exemption was appropriate because any increase in the percentage of voting rights in Kidicorp controlled by A.B.C. would be incidental to a significant merger between A.B.C. and either or both of Child Care Centres and

Peppercorn, and that merger would be directed to the provision of child care centres and related services within Australia and not to the control of the voting rights in Kidicorp (the assets of which were small in relation to the assets of A.B.C., Peppercorn, and Child Care Centres). The market capitalisation of Kidicorp was in the order of NZ$43.7 million. Child Care Centres was valued at A$108 million and Peppercorn was valued at A$235 million for the purpose of the transaction. The total transaction value was approximately A$385 million.

25. The Panel considered that the exemption was consistent with the objectives of the Code because any increase in the percentage of voting rights in Kidicorp that were controlled by A.B.C. would be a consequence of the merger which was not for the purpose of effecting an increase in the percentage of voting rights in Kidicorp.

26. Generally, in all of these acquisitions involving foreign upstream acquisitions, the Panel has granted the exemptions because the change of control was incidental to a significant merger or acquisition overseas and was subject to equivalent takeover law, or to the acquisition laws, of a reputable jurisdiction. In all of those acquisitions the assets of the Code companies were very small in relation to the assets of the upstream entities.

Takeovers Code (Origin Energy New Zealand Limited) Exemption Notice 2004

27. In 2004, Edison Mission Energy ("EME"), as part of a global sale of its international assets, entered into an agreement to sell all of the shares in its wholly-owned subsidiary Mission Energy Universal Holdings ("Universal") to Origin Energy New Zealand Limited ("Origin Energy NZ"), a subsidiary of Origin Energy Limited ("Origin"). Universal and its subsidiary, Mission Energy Pacific Holdings ("Pacific Holdings"), together held approximately 51.2% of the voting shares in Contact Energy Limited ("Contact"), a Code company, and Universal also held all of the shares in Mission Contact Finance Limited ("Mission Contact Finance"), also a Code company. Accordingly, upon settlement of the sale of Universal, Origin Energy NZ would become the controller of 51.2% of the voting rights in Contact and all of the shares in Mission Contact Finance.

28. The Panel granted an exemption to Origin Energy NZ from rule 6(1) of the Code in respect of it becoming the controller of voting rights in Contact and Mission Contact Finance as a result of its acquisition of all of the shares in Universal.

29. The exemption was subject to a number of conditions, including that Origin Energy NZ would make a takeover offer to the remaining Contact shareholders and that the consideration under that takeover offer was to be the same as the "Per-Contact Share Price" received by EME for its interest in Contact under the purchase agreement.[3]

30. It was argued that a strict application of the Code could potentially frustrate the upstream entity's sale of the Contact shares because of the potential loss of benefit to it of selling its shares at the direct holder level. This potential frustration could have unintended extraterritorial consequences in that it would frustrate an international

[3] The "Per Contact Share Price" was defined in the Purchase Agreement – Essentially, Contact shareholders would be offered, and be able to accept, the same consideration per-share under Origin's takeover offer as the per-share purchase price of Edison's interest in Contact under the sale and purchase agreement.

transaction between two foreign investors. However, the Panel noted that the sale of the Contact shares was not incidental to the acquisition, and the shares of Contact that the seller (EME) held were a significant portion of its non-US assets (roughly 20%). In fact, the only purpose of the upstream acquisition was to acquire the shares of Contact and, furthermore, despite the fact that the seller in this acquisition was incorporated in the USA, the acquisition was completely under the scope of the New Zealand law as both the upstream and downstream entities were incorporated in New Zealand.

31. The Panel considers this exemption to fall outside of the precedents discussed above and would probably not grant the same exemption in similar circumstances today.

Exemption for BG Group Plc in 2008

32. In May 2008, the Panel approved the granting of an exemption from rule 6(1) of the Code for the British company BG Group plc ("BG Group"), and several of its subsidiaries, in relation to an attempted acquisition of the Australian company, Origin, which controls, through its subsidiaries, 51.36% of New Zealand Code company, Contact. The value of the Contact shares held by Origin at the time of the application for exemption represented about 18.5% of the market value of Origin's total assets.

33. The market capitalisation of Contact at that time was around NZ$4.9 billion and the 51% interest held by Origin had a value of approximately NZ$2.5 billion. Origin had a market capitalisation of around A$8.3 billion (or NZ$9.7 billion) and BG Group had a market capitalisation of approximately £46 billion (or NZ$116 billion).

34. The terms and conditions of the exemption were never finalised and the exemption was not formally granted nor published. However, a discussion of this matter is useful as it highlights the difficulties that the Panel faced in deciding whether to approve the exemption and on what conditions.

35. In considering this exemption the Panel found itself in a difficult position because the role of the Panel itself appeared to create uncertainty in the market. Origin was already in play and the market was speculating whether there would necessarily be a takeover offer for Contact, or whether the Panel would intervene in some way and prevent a takeover offer for Contact.

36. The Panel decided that it would not be appropriate or consistent with the objectives of the Code to grant a complete exemption. The Panel also considered that this matter was outside of the scope of the precedents, as Contact appeared to represent around 25% of Origin on a market-cap basis.

37. The Panel then considered whether it might grant an exemption that would effectively postpone the obligation to comply with the Code until after the acquisition of Origin became unconditional. Under that option an exemption could have been granted from rule 6(1) of the Code for BG Group's acquisition of control of 51% of Contact, subject to the condition either that BG Group subsequently would make a Code compliant takeover offer for the remaining 49% of Contact, within a stipulated timeframe, at the same price as the implied Contact share price in the Origin offer, or

that BG Group would sell down the Origin parcel of Contact shares to 20% or less within a stipulated short timeframe.

38. After careful consideration the Panel approved the granting of an exemption to allow BG Group to obtain control of Origin while Origin was still the holder of the parcel of Contact shares. The approved exemption was subject to a condition that if BG Group's acquisition of control of Origin became unconditional (and if at that time Origin still held the Contact shares), BG Group (or a subsidiary of BG Group) would have been required, within 30 days, to make a follow-on offer in compliance with the Code for all the voting securities of Contact not already held or controlled by BG Group.

39. The Panel considered that the exemption would have been appropriate because:

(a) any acquisition by BG Group of control of voting rights in Contact, in the first instance, would be incidental to BG Group’s acquisition of Origin shares. BG Group’s acquisition of Origin shares was to be conducted under Australian law; and

(b) BG Group would be required, as a condition of exemption, once its acquisition of Origin shares was unconditional, to make a follow-on offer for the remaining Contact voting securities, and the rules of the Code would have applied to that offer.

40. The Panel considered that the exemption would have been consistent with the objectives of the Code because:

(a) in the first instance, any acquisition by BG Group of control of voting rights in Contact would be as a consequence of its acquisition of Origin shares, which was not undertaken for the purpose of gaining control of voting rights in Contact;

(b) the conditions of exemption would ensure that the minority shareholders of Contact would be offered an equivalent price for their voting securities to that received by the shareholders of Origin for the Contact shares held or controlled by Origin;

(c) the exemption would encourage competition for control of Contact; and

(d) the rules of the Code would apply to any follow-on offer made by BG Group for the remaining Contact voting securities, ensuring the fair treatment of the holders of those securities while recognising that they must ultimately decide for themselves the merits of any such offer.

41. The most difficult aspect of the proposed exemption was to consider what mechanism could appropriately be used to determine the price at which a follow-on offer should be made. It was decided that an independent expert should be appointed by the Panel to certify the value attributed to the Contact shares held by Origin (“the attribution value”). However, the more difficult issue was to decide the terms of reference for the

independent expert, including how the independent expert would assess the attribution value.

42. The Panel's intention behind the conditions of the follow-on offer exemption was to ensure that the shareholders of Contact would receive the same benefit as the Origin shareholders would obtain for the Contact investment. It appeared that a substantial premium was being offered for the Origin shares and it was difficult to assess how much of that premium was attributed to the Contact investment and how much was attributed to the other assets of Origin, particularly if the offer price were to be increased during the offer period.

43. These difficult issues were never fully resolved, as the exemption notice and terms of reference for the independent expert were not finalised due to BG Group withdrawing its exemption application when the Origin takeover failed.

44. Other potential issues for the Panel to consider in future cases might include the extent to which an independent expert should have access to commercially sensitive information to make its assessment of the attribution value.

Other exemptions

45. Besides the exemptions mentioned above the Panel has also granted a number of other exemptions in relation to upstream acquisitions.[4] However, in those cases there were no holders of voting rights in the Code company (other than the upstream target) that required the protection of the Code. Accordingly, complete exemptions from Code compliance were granted in those cases.

46. In summary, it can be said that the Panel's policy in this area has been developed on a case by case basis. In each of the cases considered by the Panel to date the focus has been on the main purpose test and also on the question of the size of the New Zealand downstream acquisition.

47. It appears that upstream acquisitions are relatively common and account for roughly 10% of all exemptions granted by the Panel. Accordingly, it would be beneficial for the Panel to develop a robust policy in respect of these transactions and to consider whether to recommend any changes to the law or whether, instead, its current exemption powers are adequate to appropriately deal with these transactions.

The Problems

48. The rules of the Code mentioned above can have serious consequences for the acquirer in the process of an upstream takeover, especially where the takeover is hostile. Unless the Panel grants an exemption from rule 6(1) of the Code, target companies could use downstream holdings of Code companies to make themselves virtually takeover proof. If an upstream target has a majority holding in a downstream Code company, it would control the outcome of any takeover of that downstream

[4] For example, the *Takeovers Code (MFS Limited) Exemption Notice 2006, Takeovers Code (Pernod Ricard S.A.) Exemption Notice 2005, Takeovers Code (Orb a.r.l.) Exemption Notice 2002, Takeovers Code (ABN AMRO Capital (Belgium) N.V.) Exemption Notice 2002* and the *Takeovers Code (Brunel Holdings plc) Exemption Notice 2002*.

company or any downstream shareholder vote under rule 7(c) of the Code, thereby potentially preventing the acquisition of the upstream target.

49. Whether or not the upstream target controls the downstream Code company, compliance with two sets of regulatory obligations in two different jurisdictions (when the downstream acquisition is only incidental to the transaction as a whole) has a negative effect on efficiency and on the market for corporate control. The problem is even more acute where a multi-national multi-billion dollar takeover can be thwarted by a holding in a relatively small downstream company which may be relatively unaffected by the upstream acquisition.

50. To date, the problem with upstream acquisitions in New Zealand has arisen mainly in respect of acquisitions occurring in a foreign jurisdiction where the upstream target held or controlled more than 20% of a New Zealand Code company ("foreign upstream acquisitions"). However, as happened in the 2004 Origin exemption, the problem can also occur domestically where both the upstream and downstream targets are incorporated in New Zealand and one or both of them are Code companies ("domestic upstream acquisitions").

51. Although the problems of inefficiency and of takeover proofing a target company are the same under both scenarios, domestic upstream acquisitions raise concerns only under domestic law, while for foreign upstream acquisitions consideration also needs to be given to the principles of international comity and the efficient implementation of foreign transactions.

52. Most of the discussion in this paper focuses on the more complex scenario of foreign upstream acquisitions. However, the paper is also relevant to domestic upstream acquisitions.

LEGAL COMPARISON

53. The following legal comparison demonstrates how other jurisdictions deal with upstream acquisitions. The main focus of this section is on the law in Australia, due to its importance both in terms of proximity and influence on New Zealand, and also because of the imperative in section 24 of the Takeovers Act to consider coordination with Australia.[5]

Australia

54. Section 606 of the Corporations Act prohibits an acquisition that increases a person's voting control in a listed company (or an unlisted company with more than 50 share parcels):

(a) from 20 per cent or below to more than 20 per cent; or

(b) from a starting point that is above 20 per cent and below 90 per cent

("the 20% rule").

[5] Please see Appendix 1 for a more in-depth discussion of upstream takeovers in Australia.

55. Item 14 of section 611 of the Corporations Act exempts from the 20% rule certain downstream acquisitions of relevant interests in shares. In particular, Item 14 of section 611 exempts downstream acquisitions that result from (upstream) acquisitions of bodies corporate that are listed on prescribed Australian stock exchanges or on foreign stock exchanges approved by the Australian Securities and Investments Commission ("ASIC") for the purpose of Item 14[6]. There is no restriction under the current law on the place of incorporation of the bidder. The exemption applies if the upstream acquisition is of relevant interests in voting shares in an Australian Code company.

Power to declare unacceptable circumstances

56. Regardless of the wide exemption in Item 14 of section 611 of the Corporations Act, section 657A of the Corporations Act still leaves the Australian Panel with the power to declare the indirect acquisition of control of the downstream company to be "unacceptable circumstances" even though, because of the exemption, no breach of section 606 of the Act has occurred.

57. An acquirer may risk a declaration of unacceptable circumstances by the Panel pursuant to section 657A(2) where the upstream body corporate is listed on a foreign stock market conducted by an approved body but:

(a) the shares in the downstream company comprise a substantial part of the assets of the upstream body corporate (in most circumstances, over 50%); or

(b) control of the downstream company is a main purpose of the upstream acquisition. For example, a recent unsuccessful takeover bid for shares in the downstream company or offer to purchase a business of the downstream company may indicate such a purpose.

Unrestricted Relief where foreign target is not listed on an approved exchange

58. In 1993, following a decision by the Federal Court in *BTR Plc v Westinghouse Brake and Signal Co (Australia) Ltd* (1992) 106 ALR 35, ASIC published Regulatory Guide 71 ("RG 71") regarding downstream acquisitions.

59. Although RG71 has been superseded by section 611 Item 14 of the Corporations Act, RG71 remains of limited application where the relevant foreign target is not listed or not listed on an approved exchange but the foreign takeover proceeds in accordance with laws generally equivalent to Chapter 6 of the Corporations Act. It sets out the policy that unrestricted relief for a downstream acquisition of an Australian Code company resulting from a takeover of a foreign listed body corporate is only granted (without a requirement for the applicant to make a downstream bid) if:

[6] ASIC Class Order 02/259 names the following foreign approved exchanges: The American Stock Exchange LLC, Deutsche Börse AG, Euronext Amsterdam NV, Euronext Paris SA, Italian Exchange SpA, JSE Securities Exchange South Africa, Kuala Lumpur Stock Exchange, London Stock Exchange plc, The NASDAQ Stock Market Inc, New York Stock Exchange Inc, New Zealand Stock Exchange, Singapore Exchange Limited, The Stock Exchange of Hong Kong Limited, Swiss Stock Exchange, Tokyo Stock Exchange, The Toronto Stock Exchange Inc. ASIC has indicated that other foreign bodies conducting stock markets can apply for approval and has set out criteria for that approval.

(a) the applicant does not propose such restriction or such a condition (meaning the requirement for the applicant to make a downstream bid);

(b) the shares in the downstream company do not comprise a substantial part of the assets of the upstream body corporate;

(c) control of the downstream company is not one of the main purposes of the takeover or merger of the upstream body corporate;

(d) the upstream acquisition is by way of a takeover or merger which is legal in the jurisdiction in which it takes place; and

(e) the jurisdiction in which the upstream takeover or merger is made, or the stock exchange on which it is made, affords a comparable level of investor protection to that under the Law and the rules of the ASX.

60. ASIC will normally regard 50% as the threshold for determining whether the downstream shares constitute "a substantial part of the assets of the upstream body corporate". If the market value of the downstream shares constitutes more than 50% of the market value of the assets of the upstream body corporate, it is likely that the acquisition of the downstream shares is the purpose of the upstream acquisition.

61. Where an applicant does not meet the criteria for unrestricted relief, ASIC may grant restricted relief. Restricted relief would normally be conditional on the applicant making a bid for the remaining shares in the downstream company at the price that was effectively offered to the upstream shareholders for the shares in the downstream company held by the upstream target.

European Communities (EC)

62. On 21 April 2004 the EC released a Directive on takeover bids (the Directive). The Directive is generally based on the UK takeover procedure. Article 5 of the Directive states:

> *(1) Where a natural or legal person, as a result of his/her own acquisition or the acquisition by persons acting in concert with him/her, holds securities of a company [governed by the laws of Member States] which, added to any existing holdings of those securities of his/hers and the holdings of those securities of persons acting in concert with him/her, directly or indirectly give him/her a specified percentage of voting rights in that company, giving him/her control of that company,*[7] *Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price as defined in paragraph 4.*
>
> *(2) Where control has been acquired following a voluntary bid made in accordance with this Directive to all the holders of securities for all their holdings, the obligation laid down in paragraph 1 to launch a bid shall no longer apply.*

[7] The threshold which control is deemed to have been acquired is defined at national level. For further information, the thresholds for making a mandatory bid in every country of the EC are provided in Appendix 2.

63. Regarding the question of whether downstream acquisitions require a further mandatory bid, subsection (2) actually only refers to the shares of the company for which the voluntary bid was made and not the shares of the downstream target which is affected by the change of control.

64. The EC law appears to always require a mandatory bid in the downstream target irrespective of whether an earlier voluntary bid has resulted in a person gaining control of the upstream body corporate. An exemption for upstream acquisitions is not provided. The purpose of this mandatory bid scheme is to protect minority shareholders by granting them a right to sell their shares in the event of a change of control as well as providing them with the benefit of the premium paid for the controlling stake. However, the Directive provides flexibility to derogate from the Directive's provisions in order to maintain Member States' exceptions from the mandatory bid rule (Art. 5(3) of the Directive).

The chain principle in the United Kingdom, Hong Kong, Singapore and Thailand

65. Some countries (United Kingdom, Thailand, Singapore and Hong Kong) deal with upstream acquisitions (referring to them as "chain acquisitions") in relation to the duty of a mandatory offer. All of these jurisdictions require, in general, a mandatory offer when the offeror acquires a certain level of voting rights in a company. In the absence of an exemption, this would require that a mandatory offer be made for the downstream Code company. However, in all of these jurisdictions an exemption from the mandatory offer requirements is available for upstream acquisitions.

United Kingdom

66. The United Kingdom procedure in the City Code on Takeovers and Mergers (the "City Code", 8th ed 20 May 2006) deals with chain acquisitions in note 8 to Rule 9.1 which provides the requirements of a mandatory offer. Note 8 provides an exception from the mandatory bid rule in the case of a chain acquisition:

> *The chain principle*
> *Occasionally, a person or group of persons acting in concert acquiring shares resulting in a holding of over 50% of the voting rights of a company (which need not be a company to which the Code applies) will thereby acquire or consolidate control, as defined in the Code, of a second company because the first company itself is interested, either directly or indirectly through intermediate companies, in a controlling block of shares in the second company, or is interested in shares which, when aggregated with those which the person or group is already interested in, secure or consolidate control of the second company. The Panel will not normally require an offer to be made under this Rule in these circumstances unless either:-*
> *(a) the interest in shares which the first company has in the second company is significant in relation to the first company. In assessing this, the Panel will take into account a number of factors including, as appropriate, the assets and profits of the respective companies. Relative values of 50% or more will normally be regarded as significant; or*
> *(b) one of the main purposes of acquiring control of the first company was to secure control of the second company.*
> *The Panel should be consulted in all cases which may come within the scope of this Note to establish whether, in the circumstances, any obligation arises under this Rule.*

67. While the mandatory bid gives every shareholder the right to exit upon a change of control, the chain principle aims at avoiding an undesirable chain effect in which the acquisition of the control of a company triggers an obligation to launch the mandatory bid along the entire company chain structure.

Hong Kong

68. Note 8 on Rule 26 of the Codes on Takeovers and Mergers and Share Repurchases from the Securities and Futures Commission Hong Kong has almost the same wording as the United Kingdom's City Code. The difference is that the relative value of the interest in shares which trigger a mandatory offer is 60% or more, rather than 50% as in the United Kingdom.

Singapore

69. The Singapore Code is based on the British wording but the circumstances for the requirement of the mandatory bid in a chain acquisition are slightly different as it states:

> *The Council will not normally require an offer to be made under this Rule in these circumstances unless the second company constitutes or contributes significantly*[8] *to the first company in the following aspects:-*
> *(a) assets;*
> *(b) market capitalisation (where the first and second companies are listed);*
> *(c) sales; or*
> *(d) earnings.*
> *Where the first company is unlisted, the pro-rated book NTA or market value of shares in the second company held by the unlisted first company is compared against the first company's book NTA. If the second company is unlisted, the pro -rated book NTA of the second company is compared against the first company's (i) book NTA; or (ii) market capitalisation.*

Thailand

70. In Thailand the same principle applies but the wording of Clause 8 of the Notification of the Securities and Exchange Commission No. GorJor. 53/2545 is different:

> *Any person, who has acquired a significant*[9] *degree of control of a juristic person with an existing shareholding in the business (immediate holding entity), either directly or indirectly through his shareholding in, or control of, other juristic persons (intermediate entity(ies)) through to the immediate holding entity (chain principle), shall make a tender offer for all securities of the business if:*
> *(1) upon the acquisition of control of such entity(ies) the aggregate holding of shares by such person, each intermediate entity, the immediate holding entity and their related parties specified in Section 258 reaches or exceeds any trigger point specified in Clause 6*
> *(2) the acquisition of control of the immediate holding entity shall include:*
> *(a) the holding of shares conferring 50 percent or more of the total voting rights in (in the case of direct control) the immediate holding entity or (in the*

[8] The Code provides no definition for this term.
[9] The Code provides no definition for this term.

> *case of indirect control) any intermediate entity, which is connected in an unbroken chain of control, through to the immediate holding entity; or*
> *(b) the power to control the management or operation of the relevant entity through the nomination of a substantial number of directors on the board of directors of such entity or the business.*
> *For the purpose of the first paragraph, the total number of shares issued by the business and held by such person in the first paragraph, each intermediate entity, the immediate holding entity, and their related parties specified in Section 258, shall be considered as shares belonging to persons of the same group for so long as such person continues to have control over the immediate holding entity.*

Germany

71. In the case of an upstream acquisition, section 35 of the Securities Takeover Act (WpÜG) imposes the duty to make a mandatory offer to the shareholders of the downstream company within five weeks after taking control of the downstream company. However, section 9 of the Regulation to the Securities Takeover Act (WpÜG-Angebotsverordnung) provides the possibility for the Federal Institute for Financial Services Supervision to provide an exemption from the obligation to make a mandatory bid if, upon the acquisition of an indirect controlling interest, the book value of the direct interest in the offeree company amounts to less than 20% of the book value of the net assets of the legal entity holding the direct interest.

72. Accordingly, our research indicates that many reputable jurisdictions provide some relief in relation to upstream acquisitions.

73. Having reviewed the status quo in New Zealand and overseas, we turn now to consider the objectives for law reform in New Zealand and what the options for reform might be.

POLICY OBJECTIVES

74. To determine whether the current regime or alternatives would be of net benefit to society by maximising the returns on available resources, options will be assessed against the objectives in section 20 of the Takeovers Act, which are set out below. It should be noted that some of these objectives, such as efficiency and procedural and substantive fairness, tend to compete with each other. Accordingly, a balance needs to be struck between such goals.

75. Section 20 sets out the following objectives of the Code:

    (a) Encouraging the efficient allocation of resources. (This objective requires an informed market with many buyers and sellers, clear property rights, and minimum barriers to trade);

    (b) Encouraging competition for the control of specified companies (i.e., Code companies. This objective requires that there are no, or low, barriers to entry or exit, and low transaction costs);

(c) Assisting in ensuring that the holders of securities in a takeover are treated fairly (this objective is interpreted as requiring equal opportunities to participate in a change of control, equivalent consideration for shares, and no compulsory taking of shares except for very good reason);

(d) Promoting the international competitiveness of New Zealand's capital markets (this objective requires reduced transaction costs and risk perceptions through encouraging confidence in the integrity of the New Zealand market);

(e) Recognising that the holders of securities must ultimately decide for themselves the merits of a takeover offer (this objective requires individual shareholders having access to adequate information and being given sufficient time to consider a takeover offer);

(f) Maintaining a proper relation between the costs of compliance with the Code and the benefits resulting from its existence (this objective requires knowledge of the costs and benefits).

76. In considering how to deal with upstream acquisitions, which frequently involve foreign transactions, often of significant value, it is also appropriate to include as an objective compliance with the principles of international comity. Certainly, in other jurisdictions the focus of the regulation of upstream acquisitions appears to fall around objectives of efficiency and international comity. In addition, any regulation should be capable of being applied transparently, so that potential acquirers can reasonably predict the application of the regulation to a proposed upstream acquisition.

OPTIONS AND ANALYSIS

77. Set out below are the proposed options. In summary they are:

(a) Option 1: Maintain status quo – comply with Code. Panel will consider all exemptions on a case by case basis.

(b) Option 2a: Class exemption with focus on purpose test[10] and 50% value test[11].

(c) Option 2b: Class exemption with focus on purpose test and 25% value test.

(d) Option 2c: Class exemption with focus on purpose test and 50% value test and requirement that upstream transaction occurs in jurisdiction with investor protection comparable to NZ (“reputable jurisdiction requirement”).

(e) Option 3: Complete exemption subject to reputable jurisdiction requirement.

(f) Option 4: Complete exemption subject to reputable jurisdiction requirement, unless unacceptable circumstances (mirrors Australian position).

[10] That is, whether the purpose of the upstream takeover is to obtain control of the downstream Code company.

[11] That is, the value of the shares held in the downstream Code company by the upstream target is 50% or more of the value of the upstream company’s assets.

Introduction

78. One of the main reasons for trying to achieve the right level of regulation for upstream acquisitions is to ensure that New Zealand meets its obligations in relation to international comity.[12] Where the purpose of the upstream acquisition is not to avoid the provisions of the New Zealand Takeovers Code, international comity would require that New Zealand legislation not impede a bona fide and otherwise lawful and appropriately regulated takeover offer for an upstream foreign body corporate.

79. International comity requires New Zealand to strive for economic efficiency in international as well as New Zealand capital markets. New Zealand regulatory requirements should not impose excessive costs or obstacles on primarily foreign business transactions unless there is clear need for New Zealand investor protection. International comity requires ensuring that New Zealand takeovers regulation is not used as an improper takeover defence by foreign bodies corporate. International comity also requires that New Zealand takeovers regulation similarly does not inhibit the liquidity and efficiency of foreign securities markets.

80. At present there is nothing in the Code, or in any class exemption from the Code, that addresses or facilitates foreign upstream acquisitions. The specific regulation of upstream acquisitions would make it possible for acquirers to recognise what conditions they have to satisfy to realise a takeover of an upstream target which has control of a significant parcel of shares in a Code company. An established policy would reduce the time and costs of the Panel, and of potential acquirers, compared to the current consideration of upstream takeovers on a case by case basis. However, in considering a policy for upstream acquisitions, the position of shareholders in the downstream Code company is also an important objective that must be weighed up.

Option 1 - status quo: exemptions considered on a case by case basis

81. To keep the status quo would mean that every upstream acquisition must either comply with an exception from the fundamental rule under rule 7 of the Code, meaning the shareholders of the downstream Code company vote on the upstream acquisition (rule 7(c) of the Code) or, alternatively, the acquirer makes a full takeover offer for the downstream Code company (rule 7(a) of the Code)). Alternatively, the acquirer may apply for an exemption from rule 6(1) of the Code. The Panel would continue to consider these applications on a case by case basis probably focusing on the 'purpose test' (that is, that the downstream acquisition was not the purpose of the upstream acquisition).

Analysis of Option 1

82. Option 1 leaves the Panel in control of the extent to which the Code should be complied with in relation to an upstream acquisition. While some may see that outcome as an advantage, others may not. It results in inefficiency, potential non-compliance with international comity and a lack of transparency. The absence of a clear policy for upstream acquisitions results in uncertainty in the market.

[12] International comity is neither a matter of absolute legal obligation, on the one hand, nor of mere courtesy and goodwill on the other. It is recognised in domestic jurisdictions, and is concerned with maintaining amicable working relationships between nations.

83. These disadvantages were evident in the recent BG Group case. It appeared that the proposed acquisition of control of Contact by BG Group, as a result of its proposed takeover of Origin, would fall well within the criteria for what ASIC called unrestricted relief in its RG 71 and would also have fallen within the current Australian regime for a complete exemption, as set out in section 611 Item 14 of the Act. The New Zealand Panel had considered whether the principle of international comity (upon which Item 14 and RG71 are based) could be applied in the BG Group case. However, the Panel was inclined to the view that the principle of international comity is not one on which the Panel should rely. This was because of matters such as the size of the Origin parcel of Contact shares (51%) and the Panel's statutory obligation to grant exemptions that are appropriate and consistent with the objectives of the Code. International comity is not an express objective of the Code. The Panel noted that when the Code was drafted, whilst the downstream consequence of an upstream change of control was expressly recognised, cross-border transactions of the nature under discussion were not expressly borne in mind.

84. When, in the BG Group case, the Panel decided not to follow the Australian model of an unrestricted exemption, it then had to consider whether BG Group should have to sell-down the Contact stake or whether it should be required to make a follow-on offer for Contact. This raised the following problems:

(a) The Panel was concerned about how it could legitimately state that an exemption, subject to conditions such as making a subsequent follow-on offer by BG Group for Contact, or selling down the Contact shares to 20% or less, was appropriate and consistent with the objectives of the Code as required by section 45(4A) of the Takeovers Act.

(b) The Panel also noted that, if a follow-on offer were required to be made, the Panel would need to consider what mechanism could appropriately be used to determine the price at which the follow-on offer should be made.

85. The complete exemptions of Normandy, Canadian National and A.B.C. have been based not only on the internationally used purpose test (which seems sensible) but also on the basis of the downstream acquisition being of a de minimus nature when compared to the value of the upstream acquisition. A problem with this test is that the de minimus test has no policy basis in the Code or in other areas of the Panel's practice. The BG Group upstream acquisition fell outside of the de minimus precedents.

Option 2a - class exemption relating to threshold and purpose test

86. Option 2a proposes a UK approach. This option proposes a class exemption from rule 6(1) of the Code for an upstream acquisition in circumstances where a person acquires control of an upstream company (which need not be a Code company) and thereby acquires or consolidates control of a downstream company (a Code company), unless:

(a) the value of the shares which the upstream company has in the downstream company is significant in relation to the upstream company. In assessing this, the Panel would take into account the assets of the respective companies. Relative values of 50% or more would be regarded as significant; or

(b) one of the main purposes of acquiring control of the upstream company was to secure control of the downstream company.

87. This option does not require that the upstream target be listed in New Zealand or overseas.

Analysis of Option 2a

88. Referring to upstream acquisitions which have been considered by the Panel so far, all cases except the 2004 Origin exemption would have fallen within the ambit of such an exemption. In Canadian National the upstream company had control of 24% of the voting rights in the downstream entity. Despite the fact that in the A.B.C. and BG Group cases the upstream targets controlled more than 50% of the voting rights in the downstream entities, the acquisition of the downstream Code company was not the purpose of the upstream acquisition and the assets of the downstream entities that were held by the upstream entity were not significant in relation to the value of the assets of the upstream entity.

89. In the 2004 Origin case the acquisition of the Contact shares was the purpose of the acquisition of the upstream targets so the 2004 Origin case would have fallen outside of the class exemption. Origin would still have had to apply for an individual exemption to comply with New Zealand takeovers law.

90. Option 2a provides transparency. Acquirers in an upstream acquisition can calculate whether they have to satisfy the Code or have to apply for an exemption from the Code and from the costs involved. In the case of a foreign upstream acquisition, New Zealand would meet its obligations in relation to international comity. The policy would ensure that the law does not impose excessive costs or obstacles on primarily foreign business transactions unless it was clear that the impacted New Zealand Code company shareholders should have the opportunity to participate in the change of control of their company. Moreover, the policy would make upstream acquisitions more efficient.

91. The significant threshold amount of 50% does not seem to be too low to make it unattractive for the acquirer to make an acquisition. By international standards it would also be not so high that the downstream shareholders would not receive adequate consideration. The policy provides an exemption for downstream acquisitions which are incidental to the acquirer’s purpose of acquiring the upstream target.

92. The main disadvantage of this option is that it grants an exemption irrespective of where the upstream target is listed or whether it is listed at all. It is not guaranteed that the upstream entity’s market is well regulated, which leaves open the opportunity for undesirable behaviours in the securities markets involved.

93. Where the downstream acquisition does not meet the criteria for the proposed class exemption, the acquirer would have to comply with the fundamental rule of the Code or apply to the Panel for an exemption. An exemption granted by the Panel, where

the class exemption could not be relied upon, could be conditional on a follow-on offer being made for the downstream company. Where control of the downstream company is one of the main purposes of the upstream acquisition, the offeror will usually be affording a benefit to the upstream shareholders in relation to the shares in the downstream company. This benefit will usually be in the form of a control premium. The Panel would have to consider how to ensure that the shareholders in the downstream company are treated fairly.

94. Although Option 2a appears to meet the objectives of efficiency, international comity and transparency, it could be argued that it sets an improper balance between the costs of the Code and the benefits of the Code's existence by avoiding most of those costs for the acquirer and avoiding the Code's benefits for the Code company shareholders. It could also be argued that it fails to meet the objective of fair treatment of Code company shareholders in that it does not provide for Code company shareholder participation if the purpose and threshold tests of the class exemption were met.

Option 2b – class exemption relating to 25% asset threshold and purpose test

95. Option 2b would be the same as option 2a, focusing on the purpose test, but it would provide a lower threshold for the value of the voting rights of the downstream company. The threshold for what is regarded as a significant relative value of the downstream entity compared to the upstream entity would be reduced to 25%.

Analysis of Option 2b

96. If Option 2b was applied to upstream acquisitions that the Panel has already considered, in each case, except the 2004 Origin case, the parties would have been able to rely on the exemption. This is because, besides the fact that the acquisitions of each of the downstream entities were not the purpose of the upstream acquisitions, none of them constituted more than 25% of the value of the assets of the upstream target.

97. Again, the advantages of efficiency, meeting international comity principles and transparency would be achieved by this option. However, it also shares the same disadvantages as Option 2a relating to no assurances of a reputably regulated upstream transaction, an improper balance between the costs and benefits of the Code (because compliance with the Code by the acquirer was exempted) and fairness to shareholders.

Option 2c – class exemption relating to 50% asset threshold, purpose test, and upstream acquisition in jurisdiction with comparable investor protection

98. Option 2c would be the same as Option 2a (that is, with the purpose test and the 50% asset valuation) but would additionally be dependant on the upstream acquisition being made in a reputable jurisdiction (being one which affords a comparable level of investor protection to that under New Zealand law). The acceptable jurisdictions would be named; quite likely they would be those currently named in the ASIC Class Order 02/259.

Analysis of Option 2c

99. Option 2c is similar to the position under the Australian RG 71. This option would have the advantage that the exemption is only available to be relied upon where it is clear that the upstream acquisition is conducted under appropriate regulatory controls.

100. This option would not unduly inhibit the liquidity and efficiency of foreign securities markets. The acquisition of unlisted upstream entities would not have the benefit of this option, which is appropriate as these transactions are not subject to the regulatory scrutiny of those whose targets are listed on approved exchanges.

101. Compared to the status quo, this option appears to provide an adequate balance between the objectives of efficiency, transparency and complying with international comity compared to the potential disadvantages for shareholders in the downstream entity in not having an opportunity to participate in the change of control.

Option 3 – complete exemption

102. Option 3 would provide a class exemption from rule 6(1) of the Code for an acquisition that results from another acquisition of voting securities in an entity listed on an approved exchange.

Analysis of Option 3

103. Under Option 3 each of the upstream acquisitions already considered by the New Zealand Panel (discussed above) would have been exempted from compliance with the Code in respect of the downstream acquisition. Even in the 2004 case of Origin, where the acquisition of Contact was the purpose of the upstream acquisition, Origin could have legitimately relied on the Option 3 exemption.

104. This option enables the unrestricted acquisition of a Code company as a downstream acquisition as long as the upstream acquisition takes place in New Zealand or another market which provides a comparable level of investor protection. The Panel would need to define the financial markets that have a comparable level of investor protection. As already stated, the Australian Class Order 02/259, which names foreign stock markets having a comparable level of shareholder protection to the Australian law, could be taken into account.

105. This option has the advantage that transactions would be efficient and New Zealand takeover law would be consistent with the principles of international comity.

106. However, the Panel would have no powers in respect of an upstream takeover whose main purpose was to take control of the downstream Code company or where the shares of the Code company comprise a substantial part (for example, more than 50%) of the assets of the upstream target. Unlike in Australia, the Panel does not have a statutory power to declare "unacceptable circumstances". The Panel would therefore have no power to intervene if an upstream acquisition was undertaken for the purpose of acquiring the downstream Code company without complying with the Code's rules for shareholder participation and a regulated takeover procedure. This option leaves the shareholders in the downstream Code company with a significant gap in their

regulatory protections. It also tips the balance of cost/benefits under the Code almost totally in favour of potential acquirers.

107. Consequently, this option could result in situations where shareholders were not treated fairly. However, it appears to meet well the objectives of efficiency, international comity and transparency.

Option 4 – complete exemption except where "unacceptable circumstances", current Australian position

108. A further option would be to have a complete exemption as set out in Option 3, subject to the condition that the Panel may intervene if it considers that there are "unacceptable circumstances", for example, that the upstream takeover is being undertaken for the purpose of acquiring shares in the downstream Code company.

Analysis of Option 4

109. Option 4 would be consistent with the principles of international comity and efficiency and would bring New Zealand in line with Australia which has a complete exemption for upstream acquisitions but has a Panel with the power to declare "unacceptable circumstances". The matters that the Panel would need to take into account before being able to declare that circumstances were unacceptable would likely mirror those prescribed for the Australian Panel (such as the effect of the circumstances on control of a company or on an acquisition in the company. The impact of any such declaration on the public interest, and other relevant policy considerations should also be required to be taken into account by the Panel).

110. Option 4 would provide adequate protection for shareholders and could ensure fair treatment of shareholders in a takeover. However, the Panel would have quite difficult decisions to make, in a commercial context where the law was being complied with by the parties, when considering whether or not to make the declaration sought (or of its own motion).

111. The power could create uncertainty in the New Zealand market due to the broad discretion given to the Panel to intervene in an otherwise lawful transaction. This could impact on market efficiency and may be argued to lack transparency. However, it appears to be accepted in Australia, where the power to declare unacceptable circumstances has been in operation for some time.

112. There may be New Zealand conventions of regulatory process in relation to this option that would require the empowering of such a broad discretion to be included in the Takeovers Act. What is not clear is whether such a broad discretion would be acceptable, either to the New Zealand public or in policy terms, given the New Zealand approach to regulation.

CONCLUSION

113. The Panel wishes to adopt a clear and transparent policy on upstream acquisitions, to provide certainty to the market and to assist the efficiency of market transactions.

114. The Panel recognises that, for each of the options above, it would still need to consider, on a case by case basis, transactions that would fall outside of the policy that the Panel settled on. In such cases, the Panel might consider whether to grant an exemption subject to a condition that the upstream acquirer sell down to 20% or less, or make a follow-on offer for the downstream Code company. Where an exemption subject to a follow-on offer is granted, the Panel would still be faced with the difficulties outlined in this paper, in particular, in deciding on the independent expert's role in determining the price for a follow-on offer.

115. It does not appear to be appropriate to maintain the status quo. New Zealand is out of step with other countries in this area, including with our closest significant neighbour, Australia.

116. It is a concern that upstream entities can effectively become "takeover proof" by holding or controlling shares in a New Zealand Code company. Furthermore it seems extremely inefficient to require compliance with the Code in respect of a downstream acquisition when the upstream acquirer does not wish to obtain control of (and may even prefer to sell off) the voting rights in the downstream entity.

117. A complete exemption may not be appropriate, as it would provide a mechanism for parties to avoid the Code where an upstream acquirer's purpose is to acquire the downstream entity. A complete exemption has been successful in Australia, but that is in the context of the Australian Panel having the power to declare "unacceptable circumstances".

118. An exemption subject to an "unacceptable circumstances" condition may result in too much uncertainty (and may, in the context of the New Zealand regulatory design rules, be difficult to achieve).

SUBMISSIONS

119. The Panel welcomes your submissions on this paper. Please see the questionnaire at Appendix 3.

APPENDIX 1: UPSTREAM TAKEOVERS IN AUSTRALIA

1. Unless a relevant exception in section 611 of the Corporations Act 2001 (Cth) applies, section 606 of the Corporations Act prohibits an acquisition that increases a person's voting control in a listed company (or an unlisted company with more than 50 share parcels):

   (a) from 20 per cent or below to more than 20 per cent; or

   (b) from a starting point that is above 20 per cent and below 90 per cent

   ("the 20% rule").

2. Item 14 of section 611 of the Corporations Act exempts from the 20% rule certain downstream acquisitions of relevant interests in shares. In particular, Item 14 of section 611 exempts downstream acquisitions that result from (upstream) acquisitions of bodies corporate that are listed on prescribed Australian stock exchanges or on foreign stock exchanges approved by the Australian Securities and Investments Commission ("ASIC") for the purpose of Item 14. There is no restriction under the current law on the place of incorporation of the bidder. The exemption applies if the upstream acquisition is of relevant interests in voting shares in a Code company. This is a return to the position as it was under section 12(k) of the Companies (Acquisition of Shares) Act and Codes ("CASA") discussed below.

3. Section 12(k) provided an exception from the 20% threshold in section 11 of CASA (predecessor of section 629 of the Corporations Act) for a downstream acquisition which resulted from an acquisition in a corporation listed on an exchange recognised by CASA. The definition of "corporation" in section 5(1) of CASA meant an Australian or a foreign company. As stated in CASA's 1980 Explanatory Memorandum this section was designed to strike out undesirable defensive tactics in a takeover. The exemption did not apply to non-listed companies because they had greater scope for misusing interposed companies to avoid the provisions of the takeover code.

4. In 1991, section 629 of the Corporations Act became the successor of section 12(k) of CASA. From 1991 until March 2000 section 629 limited the extent of the exception from the 20% rule for downstream acquisitions. First, it eliminated foreign upstream acquisitions from qualifying for exemption in relation to a downstream acquisition and, second, it confined the form of upstream acquisition to a takeover bid. The restrictions appear to have been a reaction to the takeover of a company incorporated in the United Kingdom which resulted in the change of control downstream of an Australian company, despite the fact that the upstream acquisition was regulated by neither Australian nor foreign takeover laws.[13]

[13] See *North Flinders Mines Ltd v Hartogen Energy Ltd* 14 ACLR 609. According to ASIC's Regulatory Guide, "because of the wide definition of corporation used in s12(k), the paragraph was capable of allowing the acquisition of approximately 50% of the shares in North Flinders Mines Limited (an Australian company listed on the predecessor to ASX) as a result of the acquisition of a controlling interest in Paringa Mining and Exploration Co plc (a UK company that was also listed on ASX's predecessor). Section 12(k) permitted the downstream acquisition because the upstream acquisition was a company which was listed on the predecessor to ASX. However, the acquisitions were effectively unregulated because:

(a) the UK companies regulatory system left regulation of takeovers to the City Code on Takeovers and Mergers under the London Stock Exchange's Takeovers and Mergers Panel;

5. The decision to exclude upstream acquisitions of shares in listed foreign companies was seen as a failure to take account of internationalisation of foreign companies and was inconsistent with Australia's obligations in relation to international comity by striving for economic efficiency in international as well as Australian markets. In 1994 the Legal Committee of the Companies and Securities Advisory Committee (the CASAC report) recommended a return to the previous situation by allowing an exemption for upstream acquisitions in companies that have an approved overseas exchange as their home exchange.

6. At the same time, the Federal Court in *BTR Plc v Westinghouse Brake and Signal Co (Australia) Ltd* (1992) 106 ALR 35[14] provided an analysis on how ASIC should deal with an application for relief where the applicant proposes that relief be conditional on it making a takeover bid for the remaining shares in the downstream company.

7. Following the *BTR v Westinghouse* case, ASIC published its Regulatory Guide 71 ("RG 71") regarding downstream acquisitions. RG71 took a different position from the recommendation in the CASAC report, preferring instead the approach taken in the BTR case.

8. Although RG71 has been superseded by section 611 Item 14 of the Corporations Act, RG71 remains of limited application where the relevant foreign target is not listed or not listed on an approved exchange but the foreign takeover proceeds in accordance with laws generally equivalent to Chapter 6 of the Corporations Act. It sets out the policy that unrestricted relief for a downstream acquisition of an Australian Code company resulting from a takeover of a foreign listed body corporate is only granted (without a requirement for the applicant to make a downstream bid) if:

   (a) the applicant does not propose such restriction or such a condition (meaning the requirement for the applicant to make a downstream bid);

   (b) the shares in the downstream company do not comprise a substantial part of the assets of the upstream body corporate;

   (c) control of the downstream company is not one of the main purposes of the takeover or merger of the upstream body corporate;

   (d) the upstream acquisition is by way of a takeover or merger which is legal in the jurisdiction in which it takes place; and

(b) the London Stock Exchange considered that it should not regulate companies whose primary listing was not on it but on other exchanges;

(c) after the introduction of CASA, the ASX's predecessor had removed those of its Listing Rules which regulated takeovers; and

(d) the drafting of s12(k) assumed that the acquisition in the upstream corporation was regulated so the downstream acquisition could be allowed on that presumption.

Section 629 avoids such a result by requiring the upstream body corporate to be incorporated in Australia and for the bid to be regulated by Ch 6 of the law."

[14] In this case, a company incorporated in the United Kingdom, BTR plc announced the making of a takeover bid for another company incorporated in the United Kingdom, Hawker Siddeley Group Plc ("Hawker"). Hawker held 85% of the share capital of Westinghouse Brake and Signal Co (Australia) Ltd ("Westinghouse"), a company incorporated in Australia. BTR plc applied to ASIC for relief, which was granted subject to a number of conditions. Westinghouse then applied for a review of ASIC's decision.

(e) the jurisdiction in which the upstream takeover or merger is made, or the stock exchange on which it is made, affords a comparable level of investor protection to that under the Law and the rules of the ASX.

9. ASIC will normally regard 50% as the threshold for determining whether the downstream shares constitute “a substantial part of the assets of the upstream body corporate”. If the market value of the downstream shares constitutes more than 50% of the market value of the assets of the upstream body corporate, it is likely that the acquisition of the downstream shares is the purpose of the upstream acquisition.

10. Where an applicant does not meet the criteria for unrestricted relief, ASIC may grant restricted relief. Restricted relief would normally be conditional on the applicant making a bid for the remaining shares in the downstream company at the price that was effectively offered to the upstream shareholders for the shares in the downstream company held by the upstream target.

11. In 2000, following the CASAC report, section 611 Item 14 of the Corporations Act was introduced with the result that section 606 of the Corporations Act will now not apply to a downstream acquisition that results from another acquisition of relevant interests in voting securities in an entity that is listed on an approved exchange. ASIC Class Order 02/259 names the following foreign approved exchanges: The American Stock Exchange LLC, Deutsche Börse AG, Euronext Amsterdam NV, Euronext Paris SA, Italian Exchange SpA, JSE Securities Exchange South Africa, Kuala Lumpur Stock Exchange, London Stock Exchange plc, The NASDAQ Stock Market Inc, New York Stock Exchange Inc, New Zealand Stock Exchange, Singapore Exchange Limited, The Stock Exchange of Hong Kong Limited, Swiss Stock Exchange, Tokyo Stock Exchange, The Toronto Stock Exchange Inc.

12. ASIC has indicated that other foreign bodies conducting stock markets can apply for approval and has set out criteria for that approval, including (1) that the exchange is a member of the Federation Internationale des Bourses de Valeurs, (2) that it is internationally recognised (that is, has concessional treatment and recognition in other jurisdictions), (3) has rules that meet the ASX’s listing and quotation, market information, regulatory and trading and settlement principles, (4) is in a key world trading centre and is overseen by a government regulatory authority.

13. ASIC has also indicated that it will also be relevant to an application for approval by a foreign entity that takeovers in relation to companies listed on its stock market are subject to takeover regulation designed to ensure that takeovers occur in a fully informed and competitive market; that shareholders and directors have sufficient time to identify the acquirer and to assess the merits of a takeover proposal; and ensure that all shareholders have a fair opportunity to participate in the benefits of a takeover.

14. Item 14 of section 611 of the Corporations Act exempts from the 20% rule the acquisition of over 20% of an Australian Code company as a result of an upstream acquisition. In addition, the upstream body corporate does not need to be incorporated in Australia, as long as it is listed on an approved foreign exchange. However, the listing must be a primary listing, so the exemption will not apply where a body corporate merely has a secondary listing on such an exchange.

15. Consequently, the exemption covers circumstances where an Australian Code company already has more than 20% of its voting rights controlled by a foreign company listed on an approved foreign exchange and this company is taken over in an offshore transaction. The change of control would pass without the shareholders of the downstream entity receiving an offer for their shares. The rationale behind Item 14 is that the company was already subject to the control of a foreign investor; arguably no particular harm is suffered by the other shareholders if another foreign investor takes its place. The exemption also covers domestic upstream acquisitions where the upstream company is listed on an Australian exchange.

16. However, regardless of the wide exemption in section 611 Item 14 of the Corporations Act, section 657A of the Corporations Act still leaves the Australian Panel with the power to declare the indirect acquisition of control of the downstream company to be "unacceptable circumstances" even though, because of the exemption, no breach of section 606 of the Act has occurred. The Panel's powers to declare unacceptable circumstances arise pursuant to section 657A(2) which states:

> The Panel may only declare circumstances to be unacceptable circumstances if it appears to the Panel that the circumstances:
>
> (a) are unacceptable having regard to the effect that the Panel is satisfied the circumstances have had, are having, will have or are likely to have on:
>
> (i) the control, or potential control, of the company or another company; or
>
> (ii) the acquisition, or proposed acquisition, by a person of a substantial interest in the company or another company; …
>
> The Panel may only make a declaration under this subsection, or only decline to make a declaration under this subsection, if it considers that doing so is not against the public interest after taking into account any policy considerations that the Panel considers relevant.

17. An acquirer may risk a declaration of unacceptable circumstances by the Panel where the upstream body corporate is listed on a foreign stock market conducted by an approved body but:

(a) the shares in the downstream company comprise a substantial part of the assets of the upstream body corporate (in most circumstances, over 50%); or

(b) control of the downstream company is a main purpose of the upstream acquisition. For example, a recent unsuccessful takeover bid for shares in the downstream company or offer to purchase a business of the downstream company may indicate such a purpose.

18. To prevent intervention by the Panel, such an acquirer is expected to simultaneously make a bid for the downstream company at a price which reflects a comparable premium to that offered to shareholders in the upstream target.[15]

19. The Australian Panel considered an allegation of unacceptable circumstances in the case of *Australian Pipeline Trust 01* [2006] ATP 27. The case involved two shareholders of Australian Pipeline Trust ("APT"), Alinta Limited ("Alinta") and The Australian Gas Light Company ("AGL"). AGL held 30% of APT. AGL was

[15] Robert Simkiss in *Takeovers and Reconstructions in Australia* para 510.

proposing a demerger of its energy and infrastructure business by way of a scheme of arrangement.

20. Alinta had approached AGL with a proposal to merge the two entities and then conduct a similar demerger as AGL had proposed for itself. AGL initially rejected Alinta’s proposal. Alinta had also acquired on-market 19.9% of AGL and later indicated that it might commence a hostile takeover of AGL. AGL had earlier announced a hostile takeover bid for Alinta. AGL and Alinta then entered into a Merger Implementation Agreement (“MIA”) to merge their assets, including AGL’s parcel of APT securities, subject to implementation of the scheme of arrangement. By entering into the MIA, Alinta would have acquired a relevant interest in AGL’s 30% holding in APT. However, ASIC granted relief to Alinta to the effect that Alinta would not be considered to have a relevant interest in APT securities by entering into an agreement to implement a scheme of arrangement (“the ASIC Declaration”).

21. Shortly after the ASIC Declaration, Alinta acquired a 10.25% stake in APT (“the acquisitions”). APT applied to the Takeovers Panel for a review of the ASIC Declaration. It also sought a declaration of unacceptable circumstances in relation to the acquisitions.

22. The Panel considered that it was not acceptable for a proposed acquirer of an upstream company to enter into an agreement (such as the MIA) which restricts disposal of a parcel of securities in the downstream company, and then acquire further securities in the downstream company, where the two parcels would be aggregated on implementation of the Schemes, if the proposed acquirer would not be entitled to make the downstream acquisition on implementation of the Schemes. The Panel considered in this case that this was contrary to the purpose of the exception in Item 14 and a basis for considering the circumstances were unacceptable.

23. In another case in 2008 ASIC reported that it granted restricted relief in relation to the acquisition of relevant interests in an ASX-listed downstream company resulting from a scheme of arrangement to acquire all the shares in an upstream company which was listed on the London Stock Exchange’s Alternative Investment Market (AIM) and where 53% of the shares in the Australian downstream company was its only asset. ASIC stated that the restricted relief reflected the policy in RG 71. As the upstream company held no assets other than its 53% holding in the downstream company, the purpose of acquiring the upstream company was to gain control of the downstream company. Consequently ASIC did not consider that the upstream transaction was of the kind that is intended to be covered by Item 14 and relief should not be granted in the form of an unrestricted extension of Item 14 to cover an upstream company listed on the AIM in these circumstances.

APPENDIX 2: THRESHOLD FOR GAINING CONTROL RELATING TO A MANDATORY BID IN THE EC COUNTRIES[16]

Country	Conditions triggering the obligation to make a mandatory bid
Austria	• Direct or indirect control through acquisition of more than 30% of voting rights • Indirect control through other rights conferring significant influence in the target company • Creation of controlling stake through creeping-in: acquisition of further 2% of voting rights to a controlling stake within 12 months, if the bidder does not have the majority of voting rights.
Belgium	• Acquisition of 30% of voting rights • Indirect acquisition of control of the target under certain circumstances.
Czech Republic	Acquisition of 40% of voting rights.
Cyprus	Acquisition of 30% of voting rights.
Denmark	Acquisition of shares if the acquirer: • holds the majority of voting rights in the company, • becomes entitled to appoint or dismiss a majority of the members of the board of directors, • obtains the right to exercise a controlling influence over the company on the basis of the articles of association or any agreement with the company in general, • controls the majority of voting rights pursuant to an agreement with other shareholders, or • is able to exercise a controlling influence over the company and holds more than one-third of the voting rights.
Estonia	The mandatory bid obligation is triggered when a person has gained dominant influence over the target company, and thus • holds the majority of the votes in the company, or • has the right to appoint or remove the majority of members of the supervisory board or management board, or • controls alone the majority of votes pursuant to the agreement entered into with other shareholders.
Germany	Indirect or direct acquisition of control, which is defined as 30% of the voting rights of the target company. This obligation is triggered if the threshold is overstepped by shareholders involved in a concert party arrangement even if such an arrangement is not linked to the acquisition of shares in the target company.
Greece	• Acquisition of more than one-third of the voting rights or • Acquisition of further 3% or more of the voting rights within one year in addition to holding between one-third and 50% of the voting rights.
Finland	Acquisition of 30% and 50% of the voting rights.
France	• Acquisition of more than 33.33% of the voting capital or of voting rights and • Acquisition of at least 2% more of the voting capital or voting rights within less than one year by persons holding between 33% and 50% of the voting capital or voting rights.
Hungary	• Acquisition of more than 25% of voting rights, provided that no other shareholder holds more than 10% of the voting rights of the company. • Acquisition of 33% of voting rights.
Ireland	• Acquisition of 30% of voting rights. • Consolidation of existing control position.
Italy	According to the law currently in force the obligation to make a bid arises under the following conditions: • Direct or indirect acquisition of more than 30% of the company's capital represented by shares giving the right to vote in shareholders' meetings on resolutions concerning the appointment, removal or liability of directors or members of the supervisory board.

[16] Commission of the European Communities *Report on the Implementation of the Directive on Takeover Bids* Staff Working Document SEC (2007) 268, Annex 2: 13-14. Downloaded on 7/4/09 from http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf.

Country	Conditions triggering the obligation to make a mandatory bid
	• Acquisition of more than 3% within a year of the company's capital represented by shares giving the right to vote in shareholders' meetings on resolutions concerning the appointment, removal or liability of directors or members of the supervisory board by a person already holding, directly or indirectly, more than 30% of the company's capital represented by such shares without having the majority of voting rights in the ordinary shareholders' meeting. The draft implementing rules propose to maintain such conditions.
Latvia	Acquisition of 50% of voting rights.
Lithuania	Acquisition of 40% or more of voting rights
Luxembourg	Direct or indirect acquisition of 33.33% of voting rights.
Malta	Direct or indirect acquisition of 50% plus one of the voting rights.
The Netherlands	Acquisition of 30% of voting rights.
Poland	Acquisition of more than 66% of the voting rights.
Portugal	Acquisition of one-third of voting rights (if presumption of control is not rebutted) and 50% of voting rights.
Spain	The draft law provides for a 30% voting rights threshold.
Slovakia	Acquisition of 33% of voting rights.
Slovenia	Acquisition of 25% of the voting rights.
Sweden	• Acquisition of 30% of voting rights or • Increase of 30% holding if a person attained a 30% shareholding as a result of measures taken by the company or another shareholder.
UK	• Acquisition of an interest in shares which carry 30% or more of the voting rights of a company. An interest in shares arises: through ownership of the shares; through having the right to exercise or direct the exercise of the voting rights attaching to the shares; through having the right or option to acquire the shares or call for their delivery or being under an obligation to take delivery of them by virtue of any agreement to purchase, option or derivative; and being party to a derivative whose value is determined by reference to the price of the shares and which results, or may result in, his having a long position in them. • A person (together with persons acting in concert) has an interest in shares carrying between 30% and 50% of the voting rights of a company and acquires an interest in other shares which increase the percentage of voting rights in which he is interested.

APPENDIX 3: QUESTIONNAIRE

Problem definition

A. Do you agree that there is a problem? If you do, do you consider that the discussion document explains the problem adequately? If not please explain your views:

Comment:

Policy objectives

B. Are the stated policy objectives appropriate for assessing the options included in this discussion document?

Comment:

C. Are there other objectives which you think should be included for the assessment of the options discussed, or should some of the objectives used in this discussion document be excluded? Why?

Comment:

D. Are some objectives more important than others? Why?

Comment:

Options

E. Are there any other options you believe the Panel should consider? What are they and why should they be considered?

Comment:

F. Do you agree with the Panel's assessment of the impact of the options? If not, what would your assessment be and why?

Comment:

G. What option do you prefer and why?

	YES	NO
Option 1: Maintain status quo – comply with Code. Panel will consider all exemptions on a case by case basis.	□	□
Option 2a: Class exemption with focus on purpose test[17] and 50% value test[18].	□	□
Option 2b: Class exemption with focus on purpose test and 25% value test.	□	□
Option 2c: Class exemption with focus on purpose test and 50% value test and requirement that upstream transaction occurs in jurisdiction with investor protection comparable to NZ (“reputable jurisdiction requirement”)	□	□
Option 3: Complete exemption subject to reputable jurisdiction requirement.	□	□
Option 4: Complete exemption subject to reputable jurisdiction requirement, unless unacceptable circumstances (mirrors Australian position).	□	□

Comment:

[17] That is, whether the purpose of the upstream takeover is to obtain control of the downstream Code company.

[18] That is, the value of the shares held in the downstream Code company by the upstream target is 50% or more of the value of the upstream company’s assets.