Ref: 750-100 / #68408

Guidance Note - the Takeovers Panel's exemption power

The Purpose of this Guidance Note

Since the introduction of the Takeovers Code the Panel has received a large number of applications for exemption from compliance with the Code. Many of the applications indicate that the purpose of and limitations on the Panel's exemption power are not fully understood in the market.

The purpose of this guidance note is to clarify the Panel's exemption power and to assist market participants in their appreciation of when exemptions are likely to be granted.

The Takeovers Panel's Exemption Power

The Code applies to all events which involve a change of control in excess of 20% of a code company's voting rights and provides a number of mechanisms that can be utilised to increase voting control. Companies and investors are entitled and obliged to conduct their affairs on the basis of the provisions of the Code and the protections contained within it. The Code applies equally to all market participants.

The Panel is concerned that an increasing number of market participants are seeking exemptions to avoid the need for compliance with the Code, or to enable the use of an alternative transaction structure, to achieve a particular commercial outcome or benefit. The Panel wishes to ensure that market participants appreciate the purpose of and limitations on the Panel's exemption power.

The Panel has power under section 45 of the Takeovers Act (the Act) to grant exemptions from compliance with the Code. However, the Panel is constrained by section 45(4A) which requires that the Panel's reasons for granting an exemption must include:

- why it is appropriate that the exemption is granted; and

- how the exemption is consistent with the objectives of the Code.

It is clear that the Panel's exemption power is not intended to enable market participants to avoid or modify provisions of the Code so that they can structure a transaction in a manner that does not comply with the Code.

The Code is broad in its effect and in some areas is quite prescriptive in its requirements. As a consequence in some cases the Code may have unintended consequences or may not adequately provide for unexpected or unusual circumstances. The exemption power is, therefore, necessary to deal with these situations to ensure that the Code operates effectively and efficiently and fulfils its objectives.

Some applicants for exemption seek in support of their applications to refer solely to the objectives of the Code contained in section 20 of the Act. However, these were the objectives required to be considered by the Panel in formulating the Code. The way in which these objectives were interpreted and balanced against each other can be seen in the Code that was ultimately gazetted and became law. Consequently, when considering for the purposes of an exemption application the objectives of the Code, careful consideration must be given to the various obligations and requirements of the Code itself. For example, the objective in section 20 of the Act of "*assisting in ensuring that the holders of securities in a takeover are treated fairly*" is reflected in rule 20 of the Code which provides that an offer must be made on the same terms and offer the same consideration to all shareholders of the same class.

The Panel will, therefore, in deciding whether an exemption is appropriate, consider whether compliance with the Code is possible and whether compliance would create an inappropriate, unreasonable or unintended result.

Furthermore, the exemption itself must be consistent with the objectives of the Code as embodied in the provisions of the Code. Consequently the conditions upon which exemptions are granted are designed to preserve the underlying purpose and intent of the relevant provisions of the Code.

The class exemptions contained in the Takeovers Code (Class Exemptions) Notice (No.2) 2001 demonstrate the types of situations that the Panel's exemption power is intended to address. For example a shareholder who increases its level of voting control above 20% in a code company as a result of a buyback by a company of its own shares cannot do so in compliance with the Code because the Code provides no appropriate mechanism. The Panel granted a class exemption from the fundamental rule to address this situation. The conditions of that exemption ensure that the underlying purpose and intent of the provisions of the Code are preserved by requiring either that the relevant shareholder sell down its interest within a specified time or shareholders of the code company give their prior approval to the maximum potential increase in voting control resulting from the buyback.

A review of the various specific exemptions granted by the Panel will show the same approach in a range of different circumstances where the exemption deals with compliance difficulties subject to conditions based on the objectives of the Code.

The Panel has also issued policy statements from time to time to deal with special cases. For example the Panel has issued a policy statement dealing with schemes of arrangement. A scheme of arrangement is a procedure under the Companies Act 1993 to facilitate mergers. However, the subsequent enactment of the Takeovers Act and the Code has meant that mergers by way of schemes of arrangement are unlikely to be possible without the assistance of some form of exemption from the Code. The Panel has been unwilling to see the statutory scheme of arrangement procedure for mergers rendered ineffective by the Code. Consequently, the Panel's policy is aimed at permitting mergers by way of schemes of arrangement in limited circumstances and subject to certain conditions which provide a balance between the objectives of both pieces of legislation.

The Panel has also used its exemption power to assist in the rectification of breaches of the Code where this is appropriate in the interests of all parties to a takeover transaction. An example of such a use of the exemption power was the exemption from the compulsory acquisition provisions of the Code granted to SK Foods International in relation to its takeover offer for Cedenco Foods Limited. SK Foods had failed to comply strictly with certain rules of the Code in seeking to enforce its compulsory acquisition rights and consequently was in breach of the Code. The Panel took the view that it was in the interests of all parties to allow the compulsory acquisition to proceed by way of exemption but subject

to conditions which ensured that the policy and intent of the Code in relation to the compulsory acquisition procedure was fulfilled.

Against this background of the nature of the Panel's exemption power we discuss below recent applications made to the Panel for exemptions in respect of upstream acquisitions, differential offers, scrip offers and offers for convertible securities.

Upstream acquisitions

The Code was deliberately constructed to capture the acquisition of voting rights in code companies by means of a transaction upstream from the direct holder of voting rights in the code company. Compliance with rule 7(c), which requires the approval of shareholders given at a meeting of the code company held in compliance with the requirements of the Code, is the appropriate mechanism to be utilised in respect of such upstream acquisitions. Exemptions have been sought as an alternative to this procedure. The Panel's attitude to exemptions for upstream acquisitions can be demonstrated by a discussion of a recent exemption application made by Vector Limited.

In October 2004 Vector advised that Panel that it wished to acquire control of 64.25% of the voting rights in NGC Holdings Limited which were held by a New Zealand holding company of The Australian Gas Light Company (AGL). The Code provides two alternatives which Vector could utilise to acquire control of these voting rights:

- a full takeover offer for NGC which AGL could ensure was accepted by its holding company; or

- approval by shareholders under rule 7(c) to a transaction which would result in Vector acquiring the AGL subsidiary which held the NGC shares.

The direct takeover alternative had taxation disadvantages for AGL and AGL did not wish to go through the shareholder approval process under rule 7(c).

Vector sought an exemption from rule 6(1) of the Code to enable it to become the controller of the 64.25% of the voting rights in NGC by acquiring AGL's New Zealand holding

company directly on the basis that it would also make a takeover offer for the remaining shares in NGC for the same consideration per share that was used in calculating the price for the AGL holding company.

Vector and AGL could have utilised the mechanisms which the Code provided. Instead they proposed to structure the transaction in a way that did not comply with the Code to provide taxation benefits and commercial convenience to AGL. This is not a proper ground for the exercise of the Panel's exemption power.

Vector had argued that there was a precedent for the exemption which it sought. They argued that the Panel had previously granted an exemption to Origin Energy New Zealand Limited to allow the acquisition of control over more than 50% of the voting rights in Contact Energy Limited, a code company, by means of the acquisition of a New Zealand holding company from its parent Edison Mission Energy.

The facts of the Origin Energy exemption were entirely different from those of the Vector application. The circumstances of the Origin Energy application were unique in that complex upstream financing arrangements could have resulted in a negative pricing effect for all Contact shareholders if the sale of the controlling block of shares had not taken place at the holding company level. The Panel's exemption was not granted to accommodate the commercial interests of the holder or acquirer of the controlling shareholding block. The Panel emphasises that every exemption application is treated on its own merits. Prospective applicants need to be cautious about assuming that an exemption will be granted to them on the basis of an apparently similar previous exemption.

There is one particular qualification to the Panel's policy regarding upstream transactions. The Panel has in the past granted exemptions from the fundamental rule in respect of overseas amalgamations or takeovers which have an impact on the control of the voting rights of New Zealand code companies provided they were not carried out for the purpose of increasing any person's control percentage in that code company. The Panel will only grant such exemptions where it is satisfied that the change of control of voting securities in the code company is merely incidental to the overseas transaction and the shares in the code company represent a very small percentage of the assets being acquired. An example of an

exemption granted in such a situation is the Takeovers Code (Canadian National Railway Company) Exemption Notice 2001.

Differential offers

As previously stated, rule 20 of the Code requires an offer to be made on the same terms and provide the same consideration to all shareholders of the same class. Recently the Panel has received applications for exemptions from rule 20 from bidders wishing, with the consent of the major shareholder of a code company, to offer less consideration to that shareholder than offered to remaining shareholders. These applicants have argued that smaller shareholders are not prejudiced by such an exemption and consequently it should be granted.

The most recent application in respect of a differential offer was made by Vector. After the Panel declined Vector's initial application for an exemption to enable an upstream acquisition Vector decided to make a full takeover offer for NGC. Vector proposed to offer consideration comprising of a cash sum of $2.91 per share plus a preferential entitlement to an allocation of Vector shares in the event that Vector makes a public offering of its own shares. However, Vector had agreed with AGL that its New Zealand holding company would waive its rights to the preferential entitlement and such entitlement would not be offered to it under the takeover offer. Vector sought an exemption from rule 20 to allow the differential consideration to be offered, if the Panel considered that such an exemption was required.

In support of its application Vector argued that such an exemption would be consistent with the objective contained in section 20 of the Act of "*assisting in ensuring that the holders of securities in a takeover are treated fairly*". Vector argued that because AGL was a large shareholder with a strong negotiating position that it should be allowed to agree to receive less consideration provided that this did not disadvantage other shareholders. Vector also argued that the proposed differential offer would result in remaining shareholders being treated fairly as they would be offered an additional element of consideration.

This is not a proper basis for the exercise of the Panel's exemption power. Rule 20 is a fundamental requirement of the Code and is not to be relaxed by way of exemption as a result of an assessment of the desirability or otherwise of the commercial outcome for a particular group of shareholders. Such an exemption would not be consistent with the Code.

Scrip offers and overseas shareholders

A number of offerors making scrip offers have sought exemptions from rule 20 to allow them to offer overseas shareholders cash only rather than scrip. In the absence of such exemptions offerors would be required to ensure that their offer complies with securities laws in every country where target company shareholders reside. Compliance with such overseas requirements as well as New Zealand securities law requirements increases the cost and complexity of making a scrip offer for a New Zealand code company.

In contrast with the applications regarding differential offers, exemptions in respect of scrip offers and overseas shareholders are an example of addressing a situation where the provisions of the Code have an unintended and undesirable outcome. Scrip offers are an important part of the takeovers market and yet without an appropriate exemption the existence of overseas shareholders would have an undesirable effect on the ability to make scrip offers.

Consequently the Panel has a policy that will enable it to grant exemptions from rule 20 in respect of offers to overseas shareholders but only if it is satisfied that the number of overseas shareholders in any jurisdiction is extremely small and the alternative consideration to be offered to overseas shareholders is equivalent to that being offered to remaining shareholders. The Panel's exemptions will not extend to jurisdictions where there are a significant number of overseas shareholders or where it is known that the offer can be properly made using the New Zealand offer documents. This ensures that the purpose of rule 20 is preserved.

This policy was applied in respect of exemptions granted to Independent Newspapers Limited and Normandy NFM when making scrip or scrip and cash offers. In those cases the cash offered to overseas shareholders was the net proceeds of the sale by a nominee of the scrip that would otherwise have been allotted under the offer to each overseas shareholder. This ensured that overseas shareholders were in the same position as New Zealand shareholders who immediately sold the scrip received by them under the takeover offer. In both cases the scrip offered by the bidder was listed at the time the offer was made so was easily realisable in an established market.

This policy was also applied in respect of an exemption granted to Prime Infrastructure Networks (New Zealand) Limited in respect of an offer for Powerco Limited. The Panel

granted an exemption from rule 20 to allow certain overseas shareholders, who at the time of the application held less than 1% of Powerco's total issued shares, to be offered cash provided that an independent adviser certified that the cash amount to be offered was of an equivalent value to the cash and scrip consideration offered to New Zealand shareholders. The Panel took this approach because the scrip offered was new and was not listed and it was considered that the nominee approach adopted in respect of Independent Newspapers and Normandy NFM was not appropriate. Although the certificate as to equivalence was obtained, unfortunately the exemption was exploited because of the view, supported by the rule 21 adviser and actively promoted by share brokers and advisers, that the fixed cash amount was better than the cash and scrip consideration offered to New Zealand shareholders. The number of "overseas" shareholders increased dramatically as shareholders sought to obtain the benefit of the exemption. The policy behind the exemption was consistent with the Code but unfortunately the conditions were exploited in an unexpected manner as a result of the complexity of the offer to New Zealand shareholders. The Panel will ensure that the conditions of future exemptions from rule 20 in respect of overseas shareholders do not provide the opportunity for such exploitation.

Offers for convertible securities

When a full takeover offer is made the Code requires that the offer be made for all equity securities of the target company. The Code also requires that offers for all equity securities be fair and reasonable in comparison with each other. However, if a bidder acquires convertible securities under an offer it may still be faced with the need to obtain shareholder approval under rule 7(d) before it can exercise the convertible securities and be allotted the underlying voting rights.

The Panel considers that if a bidder is required by the Code to include an offer for convertible securities under its takeover offer it should be able to exercise those convertible securities and have the benefit of the rights attaching to them without the need for shareholder approval.

An exemption to this effect has recently been granted by the Panel in respect of convertible notes that may be acquired under a takeover offer. The Panel considered that the exemption was appropriate because the increase in the applicant's percentage of voting rights would be the result of the exercise of rights attaching to securities obtained under the offer and the bidder was obliged under the Code to include those convertible securities in its offer. In

addition, in the circumstances of this exemption the increase in voting rights resulting from the exercise of the convertible notes would be the same as if the holders of the convertible notes had first converted them into shares and then accepted the offer in respect of those shares.

CONCLUSION

The Panel is a market panel and part of its role is to facilitate competition for control of code companies. However, it is not the Panel's role to grant exemptions to allow market participants to deviate from the Code purely on the basis of commercial expedience or to obtain a particular commercial benefit.

Market participants should carefully consider the provisions of the Code when proposing to increase their voting rights in a code company and must seek to structure transactions in compliance with the Code. Also, before applying for an exemption market participants should carefully consider the nature of the Panel's power as outlined in this guidance note. In addition it is important that any application contain full details of the purpose and surrounding circumstances of a transaction in respect of which an exemption is sought so that the Panel understands fully the background to the application.

January 2005

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