Ref: 740-040 / #123559

DISCLOSURE OF EQUITY DERIVATIVE POSITIONS

A CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

24 August 2012

TAKEOVERS PANEL

Introduction

1. The Panel is considering options for recommending law changes to require ongoing disclosure of equity derivative positions in public issuers. This paper queries the extent of the impact of equity derivatives on the takeovers market and discusses the Panel's preferred disclosure option.

Request for comments on this paper

2. The Panel invites submissions on the issues raised in this paper and the options identified for addressing the issues.

3. The closing date for submissions is **5 October 2012**.

4. Submissions should be sent to the Takeovers Panel for the attention of Andrew Hudson:

By email - andrew.hudson@takeovers.govt.nz

By post- Takeovers Panel
Level 3, Solnet House
70 The Terrace
P O Box 1171
WELLINGTON 6011

By fax - (04) 815 8459

Official Information Act

5. 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.

Glossary

6. This paper uses the following terms:

   (a) A **long derivative** is one in which the holder of a derivative benefits from an increase in the price of an underlying equity security, as opposed to a **short derivative** in which the holder benefits from a decrease in the price of an underlying security.

   (b) The **writer** of a derivative is the person who provides the derivative, usually an investment bank or other financial institution. The **holder** is the person who acquires the derivative, usually the bank's client.

   (c) An equity derivative can refer a specific security or an **index**. For example, an index derivative might reference the NZSX 50 or the ASX 200.

(d) **Cash-settled** derivatives are settled by the counterparties by a cash payment. **Exchanged for physical** means the underlying securities are transferred on settlement of a derivative.

(e) The **free float** of a company refers the company's shares readily available in the market.

Problem Definition

Introduction

7. The Takeovers Panel has been considering issues associated with equity derivatives and their impact on the takeovers market.

8. The Panel is concerned that long equity derivative positions of a derivative holder combined with a corresponding hedge position held by the derivative writer in underlying Code company securities may provide an opportunity for undisclosed stake building during the period leading up to a takeover bid.

9. There is currently no explicit obligation in the Code to disclose equity derivative positions in a Code-regulated transaction.

10. The Panel is considering options for recommending law changes to require ongoing disclosure by persons who hold long equity derivative positions in public issuers and to include in the Code's disclosure requirements for takeovers disclosures of relevant equity derivative positions.

Equity Derivatives

11. The term 'equity derivative' covers a range of financial instruments. Equity derivatives include options, futures and contracts for difference (also known as equity swaps in some jurisdictions). In short, an equity derivative is an arrangement under which the writer is required to pay the holder consideration that is ultimately determined, derived from, or varied by reference to (wholly or partly) the value of an underlying security or an index of securities.

12. An equity derivative gives the holder an economic exposure to the change in price of a specific security or index over the life of the contract. Derivative contracts can have an agreed termination date or can be open-ended and closed out or unwound by the holder on demand.

13. A derivative contract does not give the holder ownership of the referenced securities or any ownership rights, such as voting rights. It may, but often does not, create a right to take delivery of the underlying securities in place of cash settlement. Equity derivative contracts usually provide for adjustments related to dividend payments and share issues that take place during the life of the contract.

14. There are significant and legitimate commercial reasons for equity derivatives, including the scope to gain leverage, the ability to pursue long/short strategies and the scope to acquire a commercial interest in the underlying security in a tax efficient manner.

Australia

Australian Panel

15. The Australian Takeovers Panel has published Guidance Note 20: Equity Derivatives to assist market participants to understand the Australian Panel's approach to disclosure of equity derivatives.

16. The Australian Panel considers that non-disclosure of long equity derivative positions in a Code company may give rise to unacceptable circumstances. Where there is a control transaction, the Panel expects that all long derivative positions in the target company which already exist, or which are created, over a notional 5% threshold, and above that level changes by more than a notional 1%, will be disclosed.

17. Guidance Note 20 sets out the Australian Panel's position, which in summary, is as follows:

    (a) Equity derivatives may be cash-settled or exchanged for physical.

    (b) Equity derivatives may or may not be hedged. The derivative holder may not know the hedge status, or be able to ascertain it, or the hedge status might change frequently, or the hedge may not be the underlying securities.

    (c) There is usually no legal obligation on the derivative writer to inform the derivative holder of the hedge position.

    (d) The writer usually has an economic incentive to hedge its position, regardless of whether the derivative is cash-settled or exchanged for physical. The hedge is often established by acquiring the underlying securities.

    (e) On the unwinding of the derivative position, the writer has an economic incentive to unwind any hedge.

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

        (i) control or potential control of the company;

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

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

Australian Review

18. Over the last three years, Australian financial institutions, including the Reserve Bank of Australia and Australian Securities and Investments Commission, have conducted

a wide ranging review of the regulation and oversight of derivative markets in Australia. In June 2009, the Australian Treasury released an issues paper entitled "Improving Australia's Framework for Disclosure of Equity Derivative Products".

19. On 25 July 2012 the Australian Treasury released an exposure draft of the Corporations Legislation Amendment (Derivatives Transactions) Bill 2012. The legislation would amend the Corporations Act 2001 in Australia by introducing a framework to apply mandatory obligations to nominated classes of over-the-counter derivatives, requiring those classes to be reported, centrally cleared, or traded on suitable trading platforms. Regulations will be made to specify the details of these obligations. This legislation is intended to introduce the framework to meet Australia's G20 obligations on derivatives regulation.

<u>United Kingdom</u>

20. The City Code on Takeovers and Mergers ("City Code") is a binding set of rules that apply to listed companies in the United Kingdom. In a takeover under the City Code, parties that hold 1% or more in securities of the offeror or offeree must publicly disclose any dealings in those securities during the takeover period. The 1% threshold includes any long position held through derivatives or options, including cash-settled derivatives.

21. In addition, since 1 June 2009 long derivative positions in listed issuers are caught by an ongoing disclosure regime. The threshold for disclosure is 3% of total voting rights with further disclosure at 1% increments. Long derivative positions are aggregated with any holdings of securities when calculating whether the thresholds are met.

<u>New Zealand</u>

Ithaca (Custodians) Ltd v Perry Corporation

22. An example of how derivatives have been used in New Zealand is demonstrated in *Ithaca (Custodians) Ltd v Perry Corporation.*[1] The facts are:

    (a) Perry Corporation held shares in Rubicon Limited ("Rubicon"), which through a subsidiary had a 17.6% shareholding in Fletcher Challenge Forests ("Fletcher Forests"). Between January and April 2001 Perry Corporation increased its shareholding in Rubicon to 10.18%.

    (b) On 31 May 2001, Perry Corporation sold 31 million Rubicon shares to Deutsche Bank ("Deutsche") and UBS Warburg ("UBS") respectively, thereby reducing its shareholding to below 3%. These sales were matched by a cash-settled equity swap derivative. Perry Corporation took a long position and Deutsche and UBS, as counterparties, each held the short position. Both Deutsche and UBS hedged their position using the Rubicon shares that Perry Corporation had sold to them. The Rubicon shares were illiquid so it was understood that they would not be sold before the unwinding of the equity swap contract.

[1] [2004] 1 NZLR 731 (CA)

(c) Perry Corporation almost immediately acquired more Rubicon shares (up to just below 5%) and then in early June 2002 sold down to Deutsche with matching equity swaps. There were some further related transactions and as at 5 June 2002 Perry Corporation held 3.08% of the voting securities in Rubicon.

(d) Towards the end of June 2002, following an overnight book build in which Guinness Peat Group ("GPG") offered a premium for the shares, GPG acquired 19.87% of the shares in Rubicon. GPG had a direct shareholding in Fletcher Forests as well and opposed a plan by Rubicon to sell its Fletcher Forests shareholding. In contrast, Perry Corporation approved of the proposal. The proposal was to be put to shareholders on 19 July 2002.

(e) On 11 July 2002, Perry Corporation requested to unwind the equity swap contracts with Deutsche and UBS who agreed and cash-settled the contracts. Although there was no contractual obligation to sell the Rubicon hedge shares to Perry Corporation to close out the hedge, Deutsche and UBS sold 36 million Rubicon shares Perry Corporation. This resulted in Perry Corporation holding 15.98% of the shares and so becoming a major shareholder for the purposes of voting on the proposal to sell the Fletcher Forests shares.

(f) Perry Corporation had filed the relevant substantial security holder notices, but Perry Corporation did not disclose the derivative positions and the Deutsche and UBS hedge positions in Rubicon shares. GPG claimed that Perry Corporation should have disclosed a relevant interest in the hedge shares because the derivatives constituted an "arrangement or understanding" under the Securities Markets Act 1988. Although the Court of Appeal acknowledged that the market reality was that the hedge shares would be available for purchase by Perry Corporation, GPG's claim was ultimately unsuccessful.

23. Although not directly relevant for the takeovers market, the case does highlight the limitations with disclosure requirements under the substantial security holder regime.

<u>Substantial security holder regime/substantial product holder regime</u>

24. The Securities Markets Act provides that a person who holds a relevant interest in 5% or more of the securities in a public issuer must disclose that fact to the issuer and to the exchange on which the issuer is registered. Any change to the person's holding of 1% or more must also be disclosed.

25. The Securities Markets Act sets out the test for determining which interests are relevant for the purposes of the regime. The basic rule is that a person will have a relevant interest in a security if the person is the holder or beneficial owner of that security, has the power to acquire or dispose of the security, or has the power to control the voting, acquisition or disposal of the security (presently or in the future).

26. Disclosure of the identity of these security holders is intended to act as a deterrent to insider trading and market manipulation, prevent secret dealings in potential takeover bids and to ensure that investors and public issuers can make informed investment decisions. This disclosure regime has been carried over into the Financial Markets

Conduct Bill, currently in the House and before the Commerce Select Committee, as the substantial product holder disclosure regime.

The Takeovers Code

27. The Code sets out in Schedules 1 and 2 the disclosure that the offeror and the target company must make in a takeover transaction. The current disclosure requirements are designed to ensure transparency for shareholders and for other potential bidders in a Code-regulated takeover. The Code's current disclosure requirements do not explicitly cover equity derivative positions.

Holds or controls

28. The offeror's disclosure is limited to equity securities held or controlled in the target company by the offeror, or by any person acting jointly or in concert with the offeror, or by directors and substantial security holders of those persons.[2] The target company disclosure is likewise limited to equity securities held or controlled in the target company by directors or officers of the target and their associates or by substantial security holders.[3]

29. Under the Code, equity securities include an option or right to acquire an interest or right in the share capital of a company unless the option or right is exercisable only with the agreement of the company.

30. Equity derivatives which are cash-settled and give the holder only an economic interest in the underlying equity securities are probably not caught by these disclosure requirements as they do not give the holder any interest in, or right to an interest in, equity securities.

Is there a problem in New Zealand?

31. Based on evidence from international markets, the Panel understands that:

    (a) Persons that write long equity derivative contracts are incentivised to hedge their position by acquiring a corresponding number of underlying securities or by entering into matching short derivative positions;

    (b) When the parties unwind a derivative position, the writer of the derivative has a strong incentive to unwind any hedge position;

    (c) There is nothing preventing the writer from selling the hedge shares directly to the holder of the derivative at maturity. A sale to the derivative holder is administratively the most convenient means of disposal and reduces transaction costs and risk. Market behaviour indicates this may be common practice;

[2] Takeovers Code, Schedule 1, clauses 6 and 7
[3] Takeovers Code, Schedule 2 clauses 5, 6, and 8

(d) The derivative writer, incentivised to ensure good client relations and repeat business, would wish to accommodate a holder's desire to purchase underlying shares;

(e) The derivative holder can control the timing of the unwind;

(f) Even if the hedge shares are not sold to the derivative holder, the fact that the writer buys the underlying shares as a hedge removes them from the market and may bring about a reduction of the free float of the company, which in turn influences the control or potential control of the company.

32. In summary, the Panel is concerned that the derivative holder can effectively acquire the ability to build a stake in a Code company without disclosure, and can facilitate trading positions that may be otherwise difficult to achieve.

33. The Panel does not have evidence of the magnitude of this problem in New Zealand. It is interested to learn the views of market participants on the extent to which non-disclosure of equity derivative positions is, or may become, a problem.

Questions

1. Do you think that there is a problem that equity derivative positions are not currently required to be disclosed? Why or why not?

2. It appears that writers of equity derivative contracts typically hedge their positions by acquiring the referenced shares. From your experience, do you agree?

3. If the derivative writer hedges its position by taking up the underlying securities, how common is it in your experience for the derivative holder:

(a) to be aware of this hedging?

(b) to acquire the hedge shares from the writer when the hedge is unwound?

Policy Objectives

34. The Panel's policy objectives are:

(a) to ensure that investors and public issuers can identify the persons who have a substantial interest in public issuers in order to promote confidence in, and the international competitiveness of, the New Zealand capital markets; and

(b) to encourage the efficient allocation of resources and to encourage competition for the control of Code companies.

Options

35. The options considered by the Panel for addressing this issue are set out below.

Option 1 – Maintain the Status Quo

36. The Panel is not aware of evidence that equity derivatives are necessarily having a negative impact on the takeovers market in New Zealand. Accordingly, one option is to maintain the status quo. Under this option, the Panel would wait until there is evidence of equity derivatives having a negative impact on takeovers. The Panel could then reconsider the matter in light of that evidence.

37. This is not the Panel's preferred option. There is evidence that overseas takeovers markets have been impacted by equity derivatives, and a number of market regulators have preferred to regulate to require disclosure of equity derivative positions.

38. The equity derivative market in New Zealand will continue to grow. It may be that a takeover bidder has already had the benefit of an equity derivative position in the target company in the lead up to, or during, a takeover. If not, the Panel believes that it is only a matter of time until the use of equity derivatives has an impact on a New Zealand takeover. In addition, investors in New Zealand listed issuers currently have no way of knowing the true extent of ownership or potential ownership (i.e., through a derivative position) of a public issuer.

39. Importantly, there is likely to be substantial lead-time in bringing forward and enacting legislation to address any specific problem arising from non-disclosure of derivative positions.

40. Accordingly, maintaining the status quo does not meet the policy objectives.

Questions

5. Do you believe that the equity derivatives market in New Zealand will grow over time? Why or why not?

6. If so, do you believe that the risks arising from non-disclosure of equity derivatives will increase over time? Why or why not?

7. Do you think that it is preferable to address the issue in a proactive way, or would it be preferable to wait until evidence of market failures arise? Please give reasons.

Option 2 – Amend the Code

41. The Panel could recommend that the Code be amended to require long equity derivative positions to be disclosed by relevant parties to a takeover transaction. The Panel could recommend that Schedules 1 and 2 of the Code be amended to expressly require:

(a) an offeror and its directors to disclose any long equity derivative positions referenced to the underlying shares in the target company (along with the current disclosure requirements in clauses 5 and 6 in Schedule 1); and

(b) the target company, its directors and their associates to disclose any long equity derivative positions referenced to the underlying shares in the target company (along with the current disclosure requirements in clauses 5, 6 and 8 in Schedule 2).

42. Requiring this additional disclosure in takeover documents would add little in terms of the cost of compliance, because the documents themselves are already an accepted part of the takeover process in New Zealand. The cost of adding one further disclosure to these documents would be negligible.

43. The Panel believes that shareholders in target companies and other potential bidders would benefit from this disclosure. Shareholders and other potential bidders would have a clearer picture of the bidder's position or potential position in the target company.

44. Amending the Code would require disclosure to be made as part of a take over transaction only. In other words, the disclosure requirements would apply only after a takeover transaction had begun. In the period of time leading up to a takeover shareholders, the target company's directors and other potential bidders would have no way of knowing the true extent of ownership or potential ownership (i.e., through a derivative position) of a public issuer.

45. Option 2 would meet part (b) of the policy objective to some degree. Parties to a takeover would have better information about the bidder's ability to takeover the company. Other potential bidders would also have a clearer understanding of the ownership status of shares and therefore the extent to which they might be acquired as part of a contested takeover. However, Option 2 would not provide disclosure of the interests of other parties who might include potential competing offerors or "spoilers" and would not provide disclosure in the period leading up to a potential takeover.

46. In view of the better disclosure during a takeover, part (a) of the policy objective would probably also be met to some extent.

<u>Questions</u>

8. Do you think that requiring disclosure of long equity derivative positions only during a takeover regulated by the Code would provide adequate disclosure? Why or why not?

<u>Option 3 - Amend the substantial security/product holder disclosure and the Code – preferred option</u>

47. The Panel's preferred option is to recommend that securities legislation be amended to include a requirement for ongoing disclosure of long equity derivative positions referenced to securities of public issuers in a manner similar to substantial product holder disclosure. In addition, the Panel would recommend that the Code disclosures proposed under option 2 should also be required in the takeover documents.

48. The amendment could be effected by changing the substantial product holder disclosure to include in the definition of "substantial holding" relevant interests in derivatives, if underlying the derivative is a quoted financial product of a listed issuer, whether the derivative is quoted or not.

49. The Panel proposes that the thresholds for disclosure, currently 5% of total voting rights with further disclosure at 1% increments, are maintained, but that long derivative positions are aggregated with any relevant interests in securities in calculating whether the thresholds are met.

50. Substantial investors in capital markets would need to ensure that they had in place internal systems or procedures to recognise and report substantial product holdings, including long derivative positions. This cost would be a marginal increase on current disclosure requirements as investors in capital markets currently report on substantial security holdings. Maintaining the familiar 5% and 1% thresholds should also mitigate the costs associated with this disclosure requirement.

51. Combined with disclosure in takeover documents, ongoing equity derivative disclosure through substantial product holder disclosures would have the effect of ensuring that capital market participants were aware on an ongoing basis of the ownership or potential ownership positions in listed issuers. This knowledge should promote efficient allocation of resources and encourage competition for the control of Code companies. With the elimination of undisclosed positions in listed issuers, this knowledge should ultimately promote confidence in, and the international competitiveness of, the New Zealand capital markets.

52. Accordingly, this option best meets the policy objectives and is the Panel's preferred option.

<u>Questions</u>

9. Do you agree with the preferred option for disclosure of equity derivative positions? Why or why not?

Conclusion

53. The Panel is considering options for recommending law changes to require ongoing disclosure of long equity derivative positions in listed issuers and disclosure of these positions by relevant parties under the Code.

54. The Panel invites submissions on the issues raised in this paper and the options identified for addressing the issues.

55. The closing date for submissions is 5 October 2012.