UPSTREAM TAKEOVERS

A FURTHER CONSULTATION PAPER ISSUED BY THE TAKEOVERS PANEL

THE PREFERRED OPTION

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INTRODUCTION

1. On 17 April 2009, the Panel issued a discussion paper to explore ways of better dealing with the implications of the Takeovers Code (the "Code") for upstream acquisitions (the "April 2009 discussion paper").[1]

2. The Panel sought submissions on the April 2009 discussion paper. The consultation period closed on 12 June 2009. The Panel analysed and considered the feedback received in response to the April 2009 discussion paper. Further research was also undertaken.

3. The Panel has now identified a preferred option which is different from the options that were identified in the April 2009 discussion paper. Accordingly, the Panel is now seeking submissions on its preferred option to assist it to finalise its view.

4. This paper reiterates the problems with upstream takeovers, and the proposed options for resolving those problems, that were identified in the April 2009 discussion paper. This paper further explores the approaches taken in other jurisdictions, particularly Australia, before identifying and analysing the Panel's preferred option. The paper also summarises the submissions that the Panel received on the April 2009 discussion paper.

Request for comments on this paper

5. The Panel invites submissions on the preferred option in this paper. The closing date for submissions is **27 November 2009**.

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

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[1] While the April 2009 discussion paper referred to upstream takeovers, the Panel acknowledges that other forms of transaction can also result in the acquirer becoming the controller of voting securities in a downstream Code company, for example, a Court approved scheme of arrangement or a merger through, for example, the allotment of securities.

Application of Official Information Act 1982

7. 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.

EXECUTIVE SUMMARY

8. An upstream acquisition is an acquisition of an entity ("upstream target") in New Zealand or overseas that holds or controls voting rights in a New Zealand Code company[2] ("downstream Code company") and that results in the acquirer becoming a controller of those voting rights in the downstream Code company.

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

10. Regardless of the acquirer's purpose, an upstream acquisition may result in the need for compliance with the Code for the acquisition of control of the voting rights in the downstream Code company.

11. The April 2009 discussion paper described the problems associated with upstream acquisitions, including:

    (a) uncertainty as to the Panel's likely approach when considering specific exemptions from compliance with the Code under the status quo;

    (b) the problem of 'takeover proofing'; and

    (c) the timing and cost issues associated with having to comply with the Code in respect of the acquisition of control in the downstream Code company.

12. The April 2009 discussion paper proposed the following options for dealing with the Code implications of upstream acquisitions:

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

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[2] A Code company is defined by the Code as being a New Zealand registered company that: (a) is a party to a listing agreement with a registered exchange and has securities that confer voting rights quoted on the registered exchange's market; or (b) was within paragraph (a) at any time during the period of 12 months before a date or the occurrence of an event referred to in the Code; or (c) has 50 or more shareholders.

(b) Option 2a: Class exemption from having to take over the downstream Code company in advance of acquiring control of the upstream target, with focus on purpose test[3] and 50% value test.[4]

(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 New Zealand ("reputable jurisdiction requirement").

(e) Option 3: Class exemption subject to reputable jurisdiction requirement and upstream target being listed in that reputable jurisdiction.

(f) Option 4: Class exemption subject to reputable jurisdiction requirement, unless unacceptable circumstances.

13. The Panel sought submissions on the April 2009 discussion paper. The consultation period closed on 12 June 2009. The Panel received nine submissions.

14. After consideration of the submissions received in response to the April 2009 discussion paper, and further research, the Panel has identified a preferred option.

15. The Panel's preferred option is that:

(a) the Panel would consider granting unconditional exemptions, on a case by case basis, from rule 6(1) of the Code,[5] for an upstream acquirer, where the upstream acquisition would result in the upstream acquirer becoming the controller of more than 20% of the voting rights in a downstream Code company, if:

(i) the upstream acquisition occurs on a recognised exchange (that is, the target is listed on New Zealand Exchange Limited ("NZX"), or on a foreign exchange where there is a comparable level of investor protection to that in New Zealand);[6] and

(ii) acquiring control of the downstream Code company is not one of the main purposes of the upstream acquisition ("purpose test");

(b) if the value of the assets of the downstream Code company (on a market capitalisation basis) is less than 25% of the assets of the upstream target (on a

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[3] That is, whether the purpose of the upstream takeover is to obtain control of the downstream Code company.
[4] 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.
[5] Rule 6 is the "fundamental rule". It prohibits a person from increasing their holding or control of voting rights in a Code company above 20% of the total voting rights on issue, except by using one of the mechanisms in rule 7, which provide regulated processes for increasing above the 20% threshold.
[6] The Panel considers the following foreign exchanges to be "recognised exchanges": The Australian Securities Exchange, 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, Singapore Exchange Limited, The Stock Exchange of Hong Kong Limited, Swiss Stock Exchange, Tokyo Stock Exchange, The Toronto Stock Exchange Inc.

market capitalisation basis), the purpose test would be *prima facie* satisfied (however, the 25% value test is only a proxy for purpose, and if one of the main purposes of the upstream acquisition was, in fact, to acquire control of the downstream Code company, the meeting of the value test would be irrelevant);

(c) the Panel would be unlikely to grant an unconditional exemption if the purpose test was not satisfied or the upstream acquisition was not on a recognised exchange. However, the Panel would be likely to grant an exemption subject to the condition that the upstream acquirer either:

(i) sells down the shareholding in the downstream Code company to 20% or less and does not exercise any more than 20% of the Code company's voting rights; or

(ii) makes a follow-on offer for all of the shares in the downstream Code company.

(d) the Panel would provide guidance to the market, for example in the form of a guidance note, as to the factors that it would consider when determining whether to grant such exemptions. A draft guidance note can be found in the Appendix to this paper.

16. The Panel is seeking submissions on its preferred option to assist it to finalise its view. The Panel is also seeking submissions on the draft guidance note. The Panel is particularly interested in receiving comments and suggestions about the mechanics of the sell down and follow-on offer requirements (proposals for which are set out later in this paper).

STATUS QUO AND PROBLEM

Status quo

17. In an upstream acquisition, if the upstream target entity holds or controls more than 20% of the total voting rights in a Code company, the upstream acquirer will usually become the controller of the voting rights in the downstream Code company and must comply with the Code in respect of that downstream acquisition.[7]

18. **Before** the upstream acquirer gains control of the upstream target (and therefore of the target's voting rights in the downstream Code company), the acquirer, in order to comply with the Code, must have:

(a) obtained the approval of the downstream Code company's shareholders by way of ordinary resolution under rule 7(c) of the Code; or

[7] The question of whether an upstream acquisition results in an acquirer becoming a controller of voting rights in a downstream Code company is not always certain. There are clear cases where effective control over the downstream parcel will be achieved (for example, the takeover succeeds and the upstream acquirer obtains 100% control of the upstream entity). If the acquirer achieves less than full control of the upstream entity, the extent to which it will gain control of the downstream Code company, and therefore will be subject to the Code, will depend on the circumstances.

(b) completed a takeover of the downstream Code company under rule 7(a) of the Code.

19. If the upstream acquirer made a takeover offer for the downstream Code company, it would need to do so contemporaneously with, or in advance of, its acquisition of the upstream target. It would need to have included in the upstream takeover offer 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, until the takeover offer for the downstream Code company succeeded. Likewise, downstream shareholder approval of the upstream acquisition, under rule 7(c) of the Code, would have to have been completed before the upstream acquisition became unconditional.

20. The alternative to complying with the Code's requirements is to obtain an exemption from those requirements.

Nature of the problem

Practical difficulties

21. Compliance with the Code in respect of a downstream acquisition resulting from a proposed upstream acquisition may be complex. Where the upstream takeover is in a foreign jurisdiction, compliance with the Code would result in the acquisitions occurring in different jurisdictions with different rules and timing requirements. The expense of Code compliance may also be burdensome, particularly where the downstream acquisition is merely incidental to the upstream acquisition; even more so if the acquisition of the Code company is not desired.

22. The upstream acquirer may not want to make a takeover offer for the downstream Code company, perhaps because of the financial implications,[8] or, perhaps it would not wish to increase the control it would have over the Code company (assuming both the upstream and downstream takeovers were successful).

23. The upstream acquirer's other Code compliance option would be to obtain the Code company shareholders' approval of its acquisition of control over voting rights in the Code company, in advance of the upstream takeover becoming unconditional. However, the seeking of shareholder approval in advance of making the upstream takeover may have confidentiality implications that would make this course undesirable. Moreover, it would leave the feasibility of undertaking the upstream acquisition in the hands of the shareholders of the downstream Code company, even though the upstream target's shareholding in the downstream Code company may constitute a very small proportion of the assets of the upstream target.

24. These matters may make compliance with the Code an undesirable course for an upstream acquirer, particularly where the acquirer and target entity are in foreign

[8] The upstream acquirer must confirm it has the resources available to make a full offer for the downstream company, including for the shares held by the upstream target (clause 9, Schedule 1 of the Code).

jurisdictions. Accordingly, the status quo, in the absence of an exemption being granted by the Panel, may significantly inhibit international mergers and acquisitions involving downstream Code companies.

Takeover proofing

25. The status quo is more problematic in respect of hostile upstream acquisitions.

26. If the upstream target is a shareholder in a downstream Code company, the upstream target may be entitled to vote on a shareholder resolution to approve of the downstream acquisition, if the upstream acquirer adopted the rule 7(c) mechanism for complying with the Code. If the target had a large direct or indirect shareholding, it would have significant influence on the success (or otherwise) of the Code company shareholder vote.

27. Similarly, the upstream target company could determine the outcome of a downstream takeover offer (by not accepting into the offer) and therefore frustrate the upstream transaction, if the upstream acquirer adopted the rule 7(a) mechanism for complying with the Code.

28. Accordingly, under the status quo, in the absence of an exemption from compliance with the Code being granted by the Panel, a person could acquire a strategic parcel of voting rights in a Code company and use that holding as a defensive mechanism – a takeover proofing device.[9]

Uncertainty/lack of transparency

29. The Panel has approved the granting of five exemptions from compliance with the Code, pursuant to section 45 of the Takeovers Act, to upstream acquirers in respect of those acquirers becoming the controllers of voting rights in a downstream Code company as a result of an upstream acquisition.[10]

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[9] There is no takeover proofing problem where the upstream acquisition is not hostile, for example, where it is undertaken by way of scheme of arrangement. In these circumstances the target entity would generally co-operate with the upstream acquirer to ensure a successful outcome for the upstream takeover. However, this creates its own potential difficulties for the upstream acquirer if it preferred to seek rule 7(c) shareholder approval rather than make a rule 7(a) takeover offer for the downstream Code company. The upstream target would likely be regarded as an associate of the upstream acquirer for the purposes of the Code, so the upstream target would be prohibited by the Code from voting on a resolution of the Code company shareholders. The outcome of the vote would therefore rest solely with the disinterested shareholders. That might result in an unacceptable level of uncertainty for the upstream acquirer. However, in a friendly situation it would likely be possible to negotiate with the target to restructure or sell down its Code company shareholding so that Code compliance was not an issue.

[10] *Takeovers Code (Canadian National Railway Company) Exemption Notice 2001; Takeovers Code (Newmont Mining Corporation) Exemption Notice 2002*; *Takeovers Code (A.B.C. Learning Centres Limited) Exemption Notice 2004*; *Takeovers Code (Origin Energy New Zealand Limited) Exemption Notice 2004; Takeovers Code (ABN AMRO Craigs Limited) Exemption Notice 2008.* In addition to these four exemptions, an exemption for BG Group plc was approved by the Panel in 2008 in relation to an attempted acquisition of Origin Energy Limited which controlled approximately 51% of Contact Energy Limited. Although that exemption was approved by the Panel, it was not granted because the application was withdrawn after the upstream takeover offer failed.

30. Generally, the exemptions granted by the Panel to date have hinged on the purpose of the upstream acquisition and the size of the downstream shareholding in comparison with the total assets of the upstream target. Where the downstream acquisition was incidental to the upstream acquisition and the size of the downstream acquisition was very small in relation to the size of the total assets of the upstream target, the Panel has granted exemptions from the Code. In other cases, the Panel has granted, or approved the granting of, exemptions subject to the requirement that a follow-on offer be made for the downstream Code company.[11]

31. The Panel has also granted a number of other exemptions in relation to upstream acquisitions.[12] 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, exemptions from Code compliance were granted.

32. The exemptions that have been granted by the Panel in relation to upstream acquisitions have been granted on a case by case basis. There is no established policy in respect of upstream acquisitions. Accordingly, there is uncertainty and a lack of transparency as to whether the Panel would grant an exemption in any given case, and as to the terms and conditions of any such exemption.

Upstream takeovers in Australia and other jurisdictions

33. Many reputable jurisdictions have established exemptions and policies in respect of upstream takeovers. In most of these jurisdictions the responsible regulator appears to have residual discretion as to whether to require that an offer be made for the downstream Code company.

Australia

34. In Australia, Item 14 of Section 611 of the Corporations Act 2001 (Cth) provides an exception from the 20% rule (that is, that a person cannot acquire a relevant interest in more than 20% of an Australian Code company without complying with the takeover requirements) for upstream takeovers where the upstream target is listed on the Australian Securities Exchange ("ASX") or an approved exchange.[13]

[11] *Takeovers Code (Origin Energy New Zealand Limited) Exemption Notice 2004* and the BG Group exemption were subject to the condition that a follow-on offer be made for the downstream Code company.
[12] 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*.
[13] Approved exchanges are foreign exchanges that are named in the Australian Securities and Investments Commission's Class Order 02/259. They are: 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. They are all in reputable jurisdictions with takeover regulation that is comparable to that in Australia.

35. Item 14 is a pragmatic solution to a concern that downstream holdings should not interfere with the free transfer of shares in a broadly held upstream entity.[14] A primary reason for having relief from compliance with the 20% rule for upstream takeovers is to ensure that Australia meets its obligations in relation to international comity. That is, that Australian regulation does not impede a *bona fide* and otherwise lawful and appropriately regulated takeover offer for an upstream foreign body corporate.[15]

36. Regardless of the exception in Item 14, if it transpired that the upstream takeover had, as one of its main purposes, the acquisition of the downstream company, the Australian Takeovers Panel could make a declaration of unacceptable circumstances in respect of the downstream acquisition.[16] The Australian Panel can declare unacceptable circumstances even though the letter of the law has been complied with.[17]

37. Accordingly, regulatory action can be taken against parties to an upstream takeover, regardless of whether the transaction falls within the exception in the Corporations Act.

38. The Australian Securities and Investments Commission ("ASIC") can grant specific relief for transactions that do not fit within the exception in Item 14, for example, where the upstream target is not listed on a prescribed exchange. The basis on which ASIC might grant relief is set out in its Regulatory Guide 71 ("RG71"). RG71 states that ASIC will grant relief (without a requirement that the bidder makes a follow-on offer or undertakes other compliance requirements) ("unrestricted relief"), if:

    (a) the applicant does not propose such restrictions or such a condition (i.e., the applicant does not propose that it makes a follow-on offer or undertakes some other compliance requirement);

    (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;

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[14] *Cape Lambert MinSec Pty Ltd* [2009] ATP 12.

[15] See paragraphs 68 to 70 below for a discussion of the principles of international comity.

[16] The Panel's powers to declare unacceptable circumstances arise pursuant to section 657A(2) of the Corporations Act 2001 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] See section 657A(1) of the Corporations Act.

(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 Corporations Act 2001 and the rules of the ASX.[18]

39. 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 acquisition of control of the downstream shares is a purpose of the upstream acquisition.

40. Where unrestricted relief is inappropriate, ASIC may grant restricted relief,[19] which might require the bidder to either:

(a) make a follow-on offer for the downstream company; or

(b) not acquire any more shares in the downstream Code company and not exercise any voting rights in respect of the shares that it acquired in the downstream Code company as a result of the upstream acquisition ("voting and disposal standstills");[20] or

(c) divest the downstream shareholding to 20% or less within a set time.[21]

ASIC policy in respect of upstream acquisitions is applied narrowly

41. It appears that ASIC will apply its policy narrowly when considering whether to grant relief for upstream acquisitions. This is illustrated in a recent decision of the Australian Takeovers Panel, reviewing an ASIC decision in relation to an application for relief made by Cape Lambert MinSec Pty Ltd ("Cape Lambert").[22]

42. In May 2009, Cape Lambert entered into an agreement with the receivers and managers of CopperCo Ltd ("CopperCo") to acquire all of the shares in Copper Co's wholly owned subsidiary, Mineral Securities Ltd ("MinSec"). As a result of the

[18] This criterion is effectively the listing requirement that is now enshrined in the Item 14 exception in the Corporations Act – ASIC will be unlikely to grant unrestricted relief where the upstream target is not listed on an approved exchange. RG71 was written in November 1993 and updated in July 1996. It therefore addresses the law as it stood at July 1996. At that time, the relevant provision was section 629 of the Corporations Act, which provided an exception for upstream takeovers where the upstream target was listed and incorporated in Australia. The purpose of RG71 was to extend the exception in section 629 to upstream acquisitions of foreign entities that were listed on a recognised exchange.

[19] ASIC Regulatory Guide 71, paragraphs 71.21.

[20] The standstills would be amortised by Item 9 of section 611 of the Corporations Act, which provides for the acquisition of those shares by 'creeping'.

[21] RG71 does not include divestiture as a compliance option; however a recent decision of the Australian Takeovers Panel (*Cape Lambert MinSec Pty Ltd* [2009] ATP 12) refers to divestiture as a basis on which restricted relief might be granted.

[22] *Cape Lambert*, Ibid.

acquisition, Cape Lambert would also acquire MinSec's relevant interests of more than 20% of the voting rights in four ASX listed companies.

43. The acquisition of MinSec was conditional, among other things, on ASIC either:

    (a) confirming that the exception in Item 14 of section 611 of the Corporations Act applied to allow the acquisition of the interests in the four downstream companies; or

    (b) granting relief under RG71 in respect of the acquisition of the relevant interests in the downstream companies.

44. Cape Lambert applied to ASIC for unrestricted relief under RG71. ASIC did not definitively confirm to Cape Lambert its view as to the application of Item 14 because ASIC did not have the power to confirm the operation of the law in a way that was binding on third parties.

45. ASIC indicated that it would be unlikely to grant unrestricted relief. Accordingly, Cape Lambert amended its applications to request restricted relief, conditional on voting and disposal standstills.

46. ASIC offered to consider an alternative form of relief concurrently with the amended application. The alternative form of relief would be conditional on Cape Lambert selling the downstream shareholding to 20% or less within a set time (with a voting standstill) and committing to a follow-on offer if the sell down did not occur within the set time. The applicant indicated that it was not prepared to accept the alternative form of relief.

47. ASIC declined the application and Cape Lambert appealed to the Takeovers Panel for a review of ASIC's decisions.[23]

48. The Takeovers Panel declined to make a declaration that Item 14 applied (on the basis that it did not have the power to make a binding declaration as to the application of the law) and it rejected Cape Lambert's applications for unrestricted relief and restricted relief under RG71.

49. The Panel noted that, on a literal reading, Item 14 seemed to apply to the transaction.[24] However, the Panel affirmed ASIC's decision not to grant relief under RG71. The Panel noted that it would not grant relief if the transaction would be contrary to the policy of both Item 14 and Chapter 6 generally.[25] The Panel considered that the transactions were contrary to those policies because:

    (a) MinSec was in receivership and was listed in name only;

    (b) Item 14 was not designed to facilitate the sale of assets by a receiver and manager in an upstream entity;

[23] However, ASIC was, in principle, prepared to grant restricted relief in respect of one of the four downstream companies.

[24] ASIC also said that Item 14 applied to this case on a literal reading.

[25] Chapter 6 of the Corporations Act contains Australia's takeover rules.

(c) MinSec was wholly owned and suspended from trading, so the policy basis for reliance on Item 14, that downstream holdings should not interfere with the free transfer of shares in a broadly held upstream entity, did not apply;

(d) the proposed transaction would not give downstream shareholders enough information in relation to, and an opportunity to participate in, control transactions that affect their company;

(e) the proposed transaction would not provide the downstream or upstream shareholders with the relevant protections that the policy of Chapter 6 requires;

(f) there were alternative transaction structures open to Cape Lambert; and

(g) CopperCo's creditors should not be preferred over the shareholders in the downstream companies, notwithstanding the circumstances of administration and receivership.

50. Cape Lambert demonstrates the discretion ASIC has in applying its upstream acquisitions relief policy. ASIC will not necessarily grant relief, even where a transaction appears to fit within the Item 14 exception. Cape Lambert also illustrates that Item 14 is not black letter law. Although unacceptable circumstances were not an issue in Cape Lambert, it could be assumed that, had the transaction proceeded, and even though it fell within the Item 14 exception on its face, the Australian Takeovers Panel may have declared unacceptable circumstances.

The 'equal opportunity principle' in Australia underlies the purpose test; the purpose test underlies relief

51. Section 731 of the Corporations Act requires that, when considering whether to grant relief, ASIC must have regard to the need to ensure *"…that, as far as practicable, all shareholders of a company have equal opportunities to participate in any benefits accruing to shareholders under any proposal under which a person would acquire a substantial interest in the company" ("equal opportunity principle").*[26]

52. In *BTR Plc v Westinghouse Brake and Signal Co (Australia) Ltd*,[27] the Federal Court of Australia noted that the language of the equal opportunity principle is inapplicable to foreign upstream takeovers as it *"…is directed to a market for shares in Australia and plainly has in mind a domestic or Australian acquisition of shares*".[28] However, the Court opined that *"…the essence and spirit of the equal opportunity principle applies to takeovers, including those of an upstream kind, in the sense that shareholders in the downstream company should have the benefits of the kind to which s. 731 is directed"*.[29]

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[26] Section 731 of the Corporations Act is based on the recommendations made in the Eggleston Report (Second Interim Report, February 1969, Command No. 144).
[27] *BTR Plc v Westinghouse Brake and Signal Co (Australia) Ltd* (1992) 106 ALR 35.
[28] Ibid, paragraph 32.
[29] Idem.

53. It is accepted in Australia that where, in an upstream takeover, the downstream acquisition is one of the bidder's main objects, the bidder would usually be affording a benefit to the upstream entity's shareholders in relation to the shares in the downstream company. That benefit would usually be in the form of a control premium. The shareholders in the downstream company should therefore have a reasonable and equal opportunity to participate in any benefits accruing through the upstream acquisition.

54. However, where the downstream acquisition is merely incidental to an upstream takeover (and therefore there is no premium attributable to the downstream Code company shares) there cannot be said to be any unequal treatment of the shareholders of the downstream company.[30]

55. According to RG71, ASIC will consider whether control of the downstream company is one of the main purposes of the upstream offer, as a criterion for determining whether a benefit is being afforded to the upstream shareholders.

56. ASIC's RG71 is reported to work well and is relied upon approximately five or six times per year for upstream acquisitions that do not fall within the Item 14 exception.[31] It is believed that the Australian Panel has not declared unacceptable circumstances in relation to any upstream takeover. This is thought to indicate that the policy works well. The market is well aware of ASIC's policy on upstream takeovers (as recorded in RG71) and an upstream bidder knows that it risks a declaration of unacceptable circumstances if the upstream takeover is inconsistent with that policy.[32]

Why the requirement that the upstream target be listed?

57. The purpose test sits behind the exception provided by Item 14 of section 611 from compliance with the 20% rule. However, it would be difficult to properly articulate the purpose test in legislation, because purpose largely depends on the circumstances of each case.

58. Accordingly, it appears that in Australia a proxy for "purpose" is used in the legislation. Rather than articulate an exception based on an uncertain test, the exception applies to all upstream acquisitions where the target is listed on an approved exchange.

59. The listing requirement makes it unlikely that the upstream acquisition is an artifice having as its true object the acquisition of the downstream company. The risk of deception is reduced for listed upstream targets because:[33]

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[30] RG71, paragraph 71.11.

[31] This is based on an informal telephone discussion between an ASIC employee and a member of the New Zealand Takeovers Panel's executive staff in October 2008.

[32] The Cape Lambert decision that is discussed at paragraphs 41 to 50 above is an example of where a transaction appeared on its face to fit within the exception to the 20% rule, in Item 14 of section 611 of the Corporations Act, but the applicant appeared to take a cautious approach in applying to ASIC for unrestricted relief. Virtually no relief was granted to the applicants under RG71. It is possible that, if the acquisitions had proceeded, the Panel may have declared unacceptable circumstances in that case.

[33] ASIC Regulatory Guide 171 *Anomalies and issues in the takeover provisions*; Legal Committee of the Companies and Securities Advisory Committee *Anomalies in the takeovers provisions of the Corporations Law*

(a) listing rule spread and size requirements will apply. If the upstream target is listed, the upstream acquisition is likely to be a serious bid involving the acquisition of a substantial body corporate with a large number of shareholders (and other assets other than the downstream company shares);

(b) the upstream acquisition is likely to comply with Chapter 6 of the Corporations Act or with similar takeovers regulation overseas;

(c) it is likely that the market price for shares in the upstream body corporate is reliable. The price offered for control of the upstream body corporate can be compared against the market price. The acquisition of control over the upstream body corporate is less likely to be an artifice if the acquirer offers a price at least equal to the market price.

60. Accordingly, requiring that the upstream target be listed has the effect of indicating that the upstream takeover is *bona fide* and not an artifice to obtain the 'real' target – the downstream Code company.

Other jurisdictions

61. In the United Kingdom, the upstream takeovers policy is set out in a note to the Takeover Code, rather than in an exemption from the Code, and it appears to leave the UK Panel with some discretion. Note 8 to Rule 9.1 of the City Code on Takeovers and Mergers states that the Panel *will not normally* require an offer to be made under that Rule for the downstream company in the circumstances of an upstream takeover unless:

(a) the interest in shares which the upstream target has in the downstream company is significant in relation to the upstream target (the Panel will take into account a number of factors. Relative values of 50% or more will normally be regarded as significant); or

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

62. Rule 9.1 further states that the UK Panel should be consulted in all cases which may come within the scope of the note to establish whether, in the circumstances, any obligation for a follow-on offer for the downstream company arises.

63. Hong Kong, Singapore and Thailand's policies are similar to those of the UK and also appear to leave some discretion with the regulator.

64. In Germany, there is a duty to make an offer for the downstream company within five weeks after taking control of the upstream company. However, an exemption may be granted if, upon the acquisition of an indirect controlling interest, the book value of

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(March 1994); ASIC Information Statement 01/03 *ASIC approves overseas exchanges: safe harbour for downstream acquisitions*.

the direct interest in the downstream company amounts to less than 20% of the book value of net assets of the upstream company.

65. Article 5 of the EC Directive on Takeover Bids appears to always require a bid for 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).

OBJECTIVES OF THE CODE

66. As part of the policy framework for considering regulatory change, this paper now considers the objectives that any such change should meet. The objectives of the Code, as specified in section 20 of the Takeovers Act, are:

    (a) encouraging the efficient allocation of resources;

    (b) encouraging competition for the control of Code companies;

    (c) assisting in ensuring that the holders of securities in a takeover are treated fairly;

    (d) promoting the international competitiveness of New Zealand's capital markets;

    (e) recognising that the holders of securities must ultimately decide for themselves the merits of a takeover offer;

    (f) maintaining a proper relation between the costs of compliance with the Code and the benefits resulting from its existence.

67. In addition to the objectives of the Code as set out in the Takeovers Act, the Panel recognises that 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.

68. Another important objective discussed in the April 2009 discussion paper was New Zealand's compliance with the principles of international comity.[34]

69. International comity would require that New Zealand regulation not impede a *bona fide* and otherwise lawful and appropriately regulated takeover offer for an upstream foreign body corporate. 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

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[34] 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.

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.[35]

70. The Panel considers that compliance with the principles of international comity is an important consideration when deciding whether to grant exemptions from the Code for foreign upstream takeovers.

PROPOSED OPTIONS IN APRIL 2009 DISCUSSION PAPER

71. The April 2009 discussion paper identified six options for dealing with the problems identified with upstream takeovers (the Panel did not at that time have a preferred option). These are briefly described below.

72. The focus in the April 2009 discussion paper was on consistency with the upstream takeover policies in other jurisdictions, particularly Australia, because section 24 of the Takeovers Act requires regard to be had to any principles applying to coordination of business law with Australia.

73. The April 2009 discussion paper also focused on the principles of international comity, which is an underlying basis for the current upstream takeovers policy in Australia.

Option 1: maintain status quo

74. Option 1 would be to maintain the status quo. Where an upstream acquisition would result in the upstream acquirer becoming the controller of more than 20% of the voting rights in a downstream Code company, the upstream acquirer must comply with the Code **before** it acquires that control through the upstream acquisition. Alternatively, the upstream acquirer may apply to the Panel for an exemption from rule 6 of the Code.

Why not the preferred option?

75. Option 1 leaves the Panel in control of the extent to which the Code should be complied with in relation to upstream takeovers.

76. The Panel currently does not have a clear policy for exemptions for upstream takeovers. The status quo therefore lacks transparency. An applicant can not know in advance whether it is likely to obtain an exemption. The lack of transparency results in uncertainty, and uncertainty always increases transaction costs.

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[35] This paragraph is an adaptation of Australia's RG71, paragraph 71.4.

<u>Option 2a and 2b: (class exemptions, both subject to the purpose test with, respectively, a 50% value test or a 25% value test)</u>

77. Under Option 2a the Panel would grant a class exemption from rule 6(1) of the Code for all upstream acquisitions that result in the upstream acquirer becoming the controller of more than 20% of the voting rights in a downstream Code company unless:

    (a) the value of the shares which the upstream company has in the downstream company is significant in relation to the value of 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 ("value test"); or

    (b) one of the main purposes of acquiring control of the upstream company was to acquire control of the downstream company ("purpose test").

78. Option 2b was the same as option 2a, focusing on the purpose test, but it provided a lower threshold for the value of the voting rights of the downstream Code company in comparison to the upstream target's assets. That threshold was reduced to 25%.

Why not the preferred option?

79. Options 2a and 2b provide some level of transparency and, under either of them, New Zealand would appear to meet its obligations in relation to international comity.

80. However, the purpose test is rather uncertain and difficult to articulate as a bright line rule. Whether an upstream takeover is undertaken for the purpose of acquiring the downstream Code company is a question of fact. While a value test provides a proxy for identifying purpose, and value provides a bright line test, it is not necessarily determinative. There may be circumstances where, even though the value test has been met (whether the value threshold is 25%, 50% or some other percentage of the upstream target's assets), the downstream acquisition is in fact not incidental to the upstream takeover.

<u>Option 2c (a class exemption subject to purpose test and 50% value test and upstream target in reputable jurisdiction)</u>

81. Option 2c was the same as option 2a, focusing on the purpose test and the value test with a 50% threshold, but the exemption would also 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) ("reputable jurisdiction requirement").[36]

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[36] The acceptable jurisdictions would be named; quite likely they would be those currently named in the ASIC Class Order 02/259 (see footnote 13 above).

Why not the preferred option?

82. Option 2c has the advantage that the exemption could only be relied upon where it is clear that the upstream acquisition is conducted under appropriate regulatory controls.

83. This option is consistent with the objectives of efficiency, transparency and international comity. However, as with options 2a and 2b the purpose test itself is uncertain. While this option would resolve many of the identified problems, uncertainty was a key problem identified by submitters on the Panel's April 2009 discussion paper.

<u>Option 3 (a class exemption from the Code, provided upstream target in reputable jurisdiction)</u>

84. Under option 3, the Panel would grant a class exemption from rule 6(1) of the Code for all upstream acquisitions that result in the upstream acquirer becoming the controller of more than 20% of the voting rights in a downstream Code company, subject to the reputable jurisdiction requirement.

Why not the preferred option?

85. Option 3 would enable the unrestricted acquisition of a Code company as a downstream acquisition. This option would be efficient, transparent and consistent with international comity. This option appears to resolve all of the practical problems associated with upstream takeovers.

86. However, option 3 would leave downstream Code company shareholders with a significant gap in their regulatory protections. It tips the costs/benefits balance almost totally in favour of upstream acquirers. The exemption would apply regardless of whether the purpose of the upstream takeover was to acquire the downstream entity.

<u>Option 4 (a class exemption, as for option 3, but subject to unacceptable circumstances)</u>

87. Under option 4, the Panel would grant a class exemption, as 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. This would be similar to the Australian Panel's power to make declarations of unacceptable circumstances, as discussed in paragraphs 36 and 37 above.

Why not the preferred option?

88. Option 4 would achieve the same outcomes as those mentioned in respect of option 3, but it would not meet the objectives of certainty and transparency.

89. While Australia has a long history of its Panel having power to declare unacceptable circumstances even when the letter of the law has been complied with, New Zealand

has no such history. In New Zealand's regulatory environment it is unlikely to be acceptable for the Panel to give itself such a power by way of exemption. Moreover, while such a power would arm the Panel with regulatory flexibility to deal with all manner of unforeseen situations, it would not provide certainty for the market.

Other proposed options

90. Further options that the Panel has considered, on the basis of submissions received on the April 2009 discussion paper, include:

(a) a class exemption subject to a condition that the upstream acquirer makes a follow-on offer for the downstream Code company within a specified timeframe after completing the upstream acquisition;

(b) a class exemption subject to a condition that the upstream acquirer sells down the downstream shareholding to 20% or less within a specified timeframe after completing the upstream acquisition;

(c) a class exemption only where the downstream shareholding is *de minimus* in comparison to the total assets of the upstream target; or

(d) maintaining the status quo (that is, the Panel would consider exemption applications on a case by case basis), but with clear guidance to be given to the market of the factors to be taken into account by the Panel in considering those applications.

PREFERRED OPTION

91. After analysis and consideration of the submissions received in response to the April 2009 discussion paper, and after having undertaken further research, the Panel has now identified a preferred option. This option is set out below.

Preferred option – case by case exemptions, published guidance/policy

Key features of preferred option

92. The Panel would consider, on a case by case basis, granting unconditional exemptions from rule 6(1) of the Code for an upstream acquirer, where the upstream acquisition would result in the upstream acquirer becoming the controller of more than 20% of the voting rights in a downstream Code company, if:

(a) the upstream acquisition occurs on a recognised exchange (that is, the target is listed on NZX or a foreign exchange where there is a comparable level of investor protection to that in New Zealand;[37] and

[37] The Panel currently considers the following foreign exchanges to be "recognised exchanges": The ASX, 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, Singapore Exchange Limited,

(b) acquiring control of the voting rights in the downstream Code company is not one of the main purposes of the upstream acquisition ("purpose test").

93. If the value of the assets of the downstream Code company (on a market capitalisation basis) is less than 25% of the value of the assets of the upstream target (on a market capitalisation basis),[38] the purpose test would be *prima facie* satisfied. However, the 25% value test would be only a proxy for purpose, and if one of the main purposes of the upstream acquisition was, in fact, to acquire control of the downstream Code company voting rights, the meeting of the value test would be irrelevant.

94. The Panel would be unlikely to grant an unconditional exemption if the purpose test was not satisfied or the upstream acquisition was of a target that was not listed on a recognised exchange. However, the Panel would be likely to grant an exemption subject to the condition that the upstream acquirer elected to undertake one of the following compliance options:

(a) selling down the shareholding in the downstream Code company to 20% or less by no later than six months after the upstream acquisition becomes unconditional, and does not exercise any more than 20% of the Code company's voting rights; or

(b) making a follow-on offer for all of the shares in the downstream Code company no later than 30 days after the upstream acquisition becomes unconditional.

95. The election of the compliance option would have to be made no later than the later of:

(a) 14 days after the follow-on offer price is determined by an independent expert; or

(b) the day after the upstream acquisition becomes unconditional.

96. The Panel would provide guidance to the market, for example in the form of a guidance note, as to the factors that it would consider when determining whether to grant such exemptions. A draft guidance note is set out in the Appendix to this paper. It captures the discussion of the preferred option in this paper. Any revisions that may be made to the preferred option as a result of submissions will be reflected in the guidance note. The Panel would also be grateful for any comments on the draft guidance note itself.

The Stock Exchange of Hong Kong Limited, Swiss Stock Exchange, Tokyo Stock Exchange, The Toronto Stock Exchange Inc.

[38] This would be determined as at the date of the announcement of the upstream acquisition, but in advance of the announcement being made.

Specific requirements of a sell down or follow-on offer

97. For the sell down option, the Panel is not proposing that the upstream acquirer necessarily divests the entire shareholding in the downstream company. Rather, the Panel's proposal is that it sells down the shareholding so that it would be the holder or controller of no more than 20% of the shares in the downstream Code company (and does not exercise any more than 20% of the Code company's voting rights). The acquirer(s) of the sold down shares must themselves comply with the Code. That means that the upstream acquirer could not sell the shares to its associates unless the associates obtained the approval of the Code company shareholders, in accordance with rule 7(c) of the Code.

98. The following conditions would apply for the follow-on offer compliance option:

 (a) the consideration for the follow-on offer must be cash (or include a cash alternative) and must be determined by an independent expert appointed by the Panel, on the basis of a valuation of the downstream Code company;

 (b) the offeror must pay the reasonable fees, costs and expenses of the independent expert;

 (c) the offeror must include in the offer document for the follow-on offer a copy of the independent expert's valuation; and

 (d) any other terms and conditions of the follow-on offer, included by the offeror in the offer document, must be in a form approved by the Panel.

99. The other terms and conditions of the follow-on offer (referred to in paragraph 98(d) above) that the Panel may approve, could include:

 (a) the usual conditions of takeover offers that are made pursuant to the Code (the Panel would need to have approved the wording of these and all other conditions); and

 (b) that the requisite regulatory approvals (such as from the Overseas Investment Office or Commerce Commission) are obtained, and that the upstream acquirer will use its best endeavours in good faith to obtain all such approvals.

100. However, there could be no minimum acceptance condition included in the follow-on offer, other than that stipulated by rule 23 of the Code.[39]

101. BG Group plc's attempted upstream acquisition of Origin Energy Limited in 2008 highlighted the inherent difficulties in determining the appropriate consideration for a follow-on offer. The approach that the Panel took in the BG Group matter in 2008 was that an independent expert would have certified that the consideration to be

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[39] Rule 23 of the Code requires that, if at the date of the offer, the offeror does not hold or control more than 50% of the voting rights in the target company, the offer must be conditional on acceptances being received that, when taken together with voting securities already held or controlled by the offeror, confer on the offeror more than 50% of the voting rights in the target company.

offered under the follow-on offer was the price that the upstream acquirer would have reasonably attributed to the downstream Code company shares, when making its offer for the upstream entity (that is, the "see-through price").[40]

102. However, the see-through price may not be transparent and may be difficult or impossible to determine. The difficulties in determining the see-through price for the upstream target's downstream Code company asset can become even more acute if the upstream offer price is increased during the upstream offer period. For example, how does one determine the extent to which the increased offer price relates to the acquisition of the upstream target, and the extent to which it does (or does not) relate to the downstream acquisition?

103. Under the Panel's preferred option, the independent expert would undertake a single valuation of the downstream Code company. This option should eliminate the risk of the upstream acquirer making a derisory offer for the downstream Code company. If the upstream acquirer did not want to acquire the downstream Code company at the valuation price, it could elect instead, to sell down the downstream shareholding to 20% or less.

104. The Panel recognises that under its preferred option there would be no direct relationship between the independent expert and the downstream Code company. This may not cause too great a difficulty in respect of NZX listed downstream Code companies, as the expert would have access to relevant information disclosed under the Listing Rules and continuous disclosure obligations. However, where the downstream Code company is unlisted it may be difficult for the independent expert to have access to all information necessary to complete the valuation.

105. It might be that the directors of a downstream Code company (whether listed or unlisted) would consider that it would be in the shareholders' best interests to provide information to the expert, to ensure that the shareholders receive a fair and reasonable follow-on offer price. Would this be enough to ensure that the necessary information is provided to the expert?

106. The Panel would be interested in receiving submissions on the extent to which it is feasible and practical for an independent expert to undertake a valuation of, particularly, an unlisted downstream Code company. In particular:

(a) what information could the independent expert reasonably expect?; and

(b) how could the Panel ensure that the independent expert would receive sufficient information to undertake a robust valuation?

107. Alternatively, is there another valuation approach that could be taken to ensure that the offer price for the downstream Code company is fair and reasonable?

[40] This was consistent with the approach set out in RG71 at paragraph 71.25.

Analysis of Panel's preferred option

108. The Panel's preferred option recognises international comity by preventing both the upstream target, and the downstream Code company shareholders, from inhibiting a *bona fide* upstream takeover. It achieves this by removing the ability for an upstream target to make itself takeover proof. The preferred option does this through:

(a) unconditional exemptions from the Code if the upstream target is listed on a recognised exchange and the purpose test is met; or

(b) if (a) does not apply in any respect, exemptions with conditions that effectively delay the requirement to comply with the Code and provide the upstream acquirer with the flexibility to either sell the downstream shareholding or make a follow-on offer.

109. The Panel does not currently have an established exemption policy for upstream acquisitions. The Panel considers that its preferred option achieves certainty by setting out an exemption policy, with a certain set of rules, and which would provide clear guidance to the market of the factors that the Panel will take into account when considering applications for exemptions for upstream acquisitions.

110. The Panel considers that its preferred option is both pragmatic and consistent with the objectives of the Code. In particular, the efficient allocation of resources objective and the cost/benefit objective would be met by the preferred option being implemented.

111. The Panel would have a clear, published policy on upstream takeovers. Accordingly, upstream acquirers would know in advance the criteria that the Panel would assess in considering whether it will grant an exemption. Where an upstream acquirer satisfies the Panel's policy and an unconditional exemption is granted, compliance costs will be reduced for the upstream acquirer. The Panel considers that the preferred option provides an appropriate balance between the costs for the upstream acquirer on the one hand and any effect on the downstream Code company shareholders on the other.

112. The Panel considers that it would generally be appropriate to exempt upstream acquirers from having to comply with the Code for an incidental acquisition of control of a downstream Code company where compliance with the Code would result in a change of control following a large international or domestic transaction that would have no effect on the downstream Code company's shareholders. In this regard, the Panel accepts the position adopted in Australia that, provided the purpose test is met, there is no benefit for the target company shareholders relating to the acquisition of control of the downstream company and, therefore, no reason for the downstream Code company shareholders to be involved in the transaction.

113. Some of the submitters on the April 2009 discussion paper suggested that the Panel grants a class exemption based on a purpose and value test. Some of these submitters suggested that the Panel should have discretion to intervene in the transaction, notwithstanding that the purpose test had, or had not, been met.

114. Because the purpose test is uncertain, difficult to articulate, and would require Panel discretion, a class exemption based on the purpose test would not achieve certainty. In almost all of the submissions received on the Panel's April 2009 discussion paper, the problem with upstream takeovers was identified as being uncertainty in the market as to whether the Panel would grant an exemption in any particular case.

115. The Panel considers that the preferred option both provides certainty and transparency, and is consistent with other jurisdictions where discretion is given to the regulator as to whether exemptions should be granted or relief given. In particular, the preferred option is consistent with the Australian approach as set out in RG71 (except that the value test for determining purpose is lower in the Panel's preferred option (25%) than in RG71 (50%)).

116. In Australia, the starting point for relief for upstream acquisitions is the exception in Item 14 of section 611 of the Corporations Act, with the safety net of the Australian Panel being able to declare unacceptable circumstances. It seems appropriate that the starting point in New Zealand should be consistent with the approach in RG71, as the New Zealand Panel does not have the power to declare unacceptable circumstances.

CONSULTATION

117. The April 2009 discussion paper was released on 17 April 2009 and the closing date for submissions was 12 June 2009. The Panel received nine submissions in total. Six of these were from major law firms in New Zealand that offer advice on takeover activity. Submissions were also received from an investment banker, an individual investor and the New Zealand Law Society.

Problem definition

118. In answer to the question in the discussion document relating to whether there is a problem that requires fixing, all submitters agreed that there is a problem and that the discussion document explains the problem adequately. Some submitters commented on and agreed with the specific problems addressed in the paper. However, most submissions identified the main problem as being uncertainty as to whether the Panel would grant an exemption and, if so, on what terms.

Policy objectives

119. All of the respondents either generally agreed with the policy objectives used in the discussion document or made no comment on them. In relation to the question asking whether other objectives should be included for assessing the options, respondents largely made no comment or indicated that no other objectives were necessary. However, two of the submitters suggested that principles of international comity, transparency and certainty should be included as policy objectives.

120. In response to the question asking whether some objectives are more important than others, respondents generally made no comments. However, one submitter was strongly of the view that the fair treatment of shareholders objective is the most important principle and is more important than the principles of international comity.

One submitter suggested that the objective of promoting the international competitiveness of New Zealand's capital markets and the cost/benefit objective require particular consideration. Another submitter commented that, in the context of upstream takeovers, the principles of international comity are more important than the objective of encouraging competition for control.

Assessment of options

121. In response to the question regarding which was the preferred option, there were varying views.

Summary of submitters' preferred options

122. Two submitters preferred option 2a (a class exemption subject to purpose test and 50% value test). Another submitter was in favour of option 2b (a class exemption with focus on purpose test and 25% value test), but with Panel discretion to intervene where appropriate.

123. One submitter preferred either option 2a or 2c (a class exemption with focus on purpose test and 50% value test and reputable jurisdiction requirement). That submitter noted that any option with a certain set of rules, complemented by the Panel's power to grant specific exemptions where appropriate, would be preferable.

124. Two submitters were in favour of option 2c, but with a lower threshold for value (for example, 25%). One of those submitters also proposed a further option that was not included in the April 2009 discussion paper. The further proposed option was a class exemption for upstream takeovers, as for option 3 (a class exemption subject to the upstream target being listed on a prescribed exchange) but subject to: (a) a reputable jurisdiction requirement; and (b) the acquirer providing the Panel with an enforceable divestment undertaking under section 31T of the Takeovers Act, in a form acceptable to the Panel (analogous to the divestment undertakings provided to the Commerce Commission under section 69A of the Commerce Act 1986).

125. One submitter was in favour of either option 2b or option 2c. That submitter considered that a reputable jurisdiction requirement might be appropriate but that there should be no distinction between listed and unlisted upstream entities.

126. One submitter preferred an alternative option, being a 'predominant purpose test'. The predominant purpose test would contain a value test but it would not be an entrenched black letter rule. The test would provide safe harbour rules but the Panel would have discretion to intervene.

127. Another submitter preferred another alternative option, being a class exemption for upstream takeovers based on the purpose test. However, that class exemption would be subject to a condition that a follow-on offer be made for the downstream Code company at fair value.

Unacceptable circumstances?

128. No submitter was in favour of option 3 (a class exemption where target listed on prescribed exchange) or option 4 (a class exemption as in option 3 but with the Panel having discretion to declare unacceptable circumstances). The Panel having the power to declare unacceptable circumstances was regarded by all submitters as inappropriate. Generally the comments in relation to unacceptable circumstances were that it would increase rather than decrease uncertainty around Code compliance obligations for upstream takeovers. One submitter also commented that complaints of unacceptable circumstances are often used in Australia as tactical tools by transaction participants. That submitter and another submitter both commented that it is possible that a similar approach may occur in New Zealand if unacceptable circumstances were introduced. One submitter also commented that the introduction of a new concept, by way of exemption rather than through the usual regulatory processes (an amendment to the Code or the Act) would not be appropriate.

Class exemption subject to purpose test?

129. All but one of the submitters agreed that a class exemption, subject to a purpose test, would be appropriate.[41] One submitter was of the view that a class exemption, subject to a purpose test, should also be subject to a condition that always requires the upstream acquirer to make a follow-on offer.

130. The other submitters who were in favour of a class exemption, subject to a purpose test, had differing views as to how the purpose test should be applied. There were also differing views as to whether a value test would be appropriate, and, if it were appropriate, the level at which the value test should be set.[42] One submitter noted the difficulties that an upstream acquirer might have in determining value.[43]

Listed in reputable jurisdiction?

131. Eight of the nine submitters were of the view that there should be no distinction between whether the upstream target is listed or unlisted. The other submitter made no comment on this issue.

132. Six submitters commented that, based on the information in the discussion paper, a reputable jurisdiction requirement appeared to be unnecessary. One submitter noted that there may be some pragmatic benefits to adopting a reputable jurisdiction

[41] That is, Option 2a (a class exemption from having to take over the downstream Code company in advance of acquiring control of the upstream target, with focus on purpose test and 50% value test); or Option 2b (a class exemption with focus on purpose test and 25% value test); or Option 2c (a class exemption with focus on purpose test and 50% value test and requirement that upstream transaction occurs in jurisdiction with investor protection comparable to New Zealand).

[42] Four submitters considered that the value test should be less than 50%, i.e. somewhere between 25% and 40%. Three submitters considered that the value test should be 50% while the remaining two submitters did not specify a threshold.

[43] The necessary information may not be available to the bidder. Also, events might arise after balance date which affect the value but are not known to the bidder.

requirement, but that there does not appear to be any obvious principles-based justification for the reputable jurisdiction requirement. The submitter commented that the introduction of such a requirement could promote avoidance, but no reasons were given for that view.

133. Two submitters were in favour of a reputable jurisdiction requirement. Those submitters did not provide reasons for their views. However, one of the submitters noted that this requirement would reduce the risk of abuse of any class exemption, although that risk was thought to be negligible, given that the purpose test would also be included.

Panel discretion?

134. Three submitters were of the view that any class exemption based on a purpose test should leave some discretion for the Panel to intervene if the Panel believed that the purpose of the upstream takeover was to acquire the downstream Code company, even though a prescribed 'purpose test' might have been met. It was also submitted that, even if the purpose test were not met on its face, the Panel should be able to approve an upstream takeover (that is, grant a specific exemption) where it was clear to the Panel that the purpose of the upstream takeover is not to acquire the downstream Code company.

135. One submitter commented that, if the Panel grants a class exemption whereby it retains some discretion, the Panel should be notified in advance of the upstream acquirer's reliance upon the exemption, so that the Panel is able to exercise that discretion.

136. One submitter commented that the purpose test would provide the Panel with a broad and appropriate discretion to guard against avoidance of the Code. If the Panel considered that the purpose test was not satisfied, it would have the usual array of enforcement tools, as set out in the Takeovers Act, available to it. However, that submitter, and others, commented that the Panel should provide guidance to the market as to how it would apply the purpose test and what factors it would take into account.

Other comments

137. One submitter suggested that the Panel publish a guidance note as to the matters and shareholding thresholds which it considers may constitute a change in control in a downstream Code company as a result of an upstream takeover.[44]

SUBMISSIONS

138. The Panel is grateful for the effort undertaken by submitters on the April 2009 discussion paper.

[44] For the time being the Panel does not propose to publish such a guidance note, as every case needs to be judged on its own merits taking into account all of the relevant circumstances. Market participants are encouraged to contact the Panel executive to discuss their particular circumstances as the need arises.

139. The Panel now welcomes submissions on its preferred option and the draft guidance note in the Appendix.

APPENDIX

Draft Guidance Note – Principles for granting of exemptions for upstream acquisitions

What is an upstream acquisition?

1. An upstream acquisition is an acquisition that occurs in New Zealand or overseas, that results in the acquirer of the upstream target becoming a controller of voting rights in a New Zealand Code company.[1] This acquisition of control occurs because the upstream target holds or controls voting rights in that Code company and that asset (i.e., the voting rights) is acquired as part of the acquisition of the upstream target entity.

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

Application of the Code

3. In an upstream acquisition, if the upstream target entity holds or controls more than 20% of the total voting rights in a New Zealand Code company, the upstream acquirer will usually also become the controller of the voting rights in the downstream Code company and must comply with the Code in respect of that downstream acquisition.

4. The question of whether an upstream acquisition results in an acquirer becoming a controller of voting rights in a downstream Code company is not always certain. There are clear cases where effective control over the downstream parcel will be achieved (for example, the takeover succeeds and the upstream acquirer obtains 100% control of the upstream entity). If the acquirer achieves less than full control of the upstream entity, the extent to which it will gain control of the downstream Code company, and therefore will be subject to the Code, will depend on the circumstances.

Prior shareholder approval or prior takeover offer

5. **Before** the upstream acquirer gains control of the upstream target (and therefore of the target's voting rights in the downstream Code company), in order to comply with the Code, the acquirer must have:

   (a) obtained the approval of the downstream Code company's shareholders by way of ordinary resolution under rule 7(c) of the Code; or

[1] A Code company is defined by the Code as being a New Zealand registered company that: (a) is a party to a listing agreement with a registered exchange and has securities that confer voting rights quoted on the registered exchange's market; or (b) was within paragraph (a) at any time during the period of 12 months before a date or the occurrence of an event referred to in the Code; or (c) has 50 or more shareholders.

(b) completed a takeover of the downstream Code company under rule 7(a) of the Code.

6. If the upstream acquirer made a takeover offer for the downstream Code company, it would need to do so contemporaneously with, or in advance of, its acquisition of the upstream target. It would need to have included in the upstream takeover offer 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, until the takeover offer for the downstream Code company succeeded. Likewise, downstream shareholder approval of the upstream acquisition, under rule 7(c) of the Code, would have to have been completed before the upstream acquisition became unconditional.

7. The alternative to complying with the Code's requirements is to obtain an exemption from those requirements.

Application for exemption

8. The Panel will consider applications for exemptions from the Code in relation to upstream acquisitions on a case by case basis.

Unconditional exemption if purpose test met

9. The Panel may grant unconditional exemptions from rule 6(1) of the Code for an upstream acquirer, where the upstream acquisition would result in the upstream acquirer becoming the controller of more than 20% of the voting rights in a downstream Code company, if:

   (a) the upstream acquisition occurs on a "recognised exchange" (as described below); and

   (b) acquiring control of the voting rights in the downstream Code company is not one of the main purposes of the upstream acquisition ("purpose test").

10. If the value of the assets of the downstream Code company is less than 25% of the value of the assets of the upstream target, the purpose test will be *prima facie* satisfied (however, the 25% value test is only a proxy for purpose, and if one of the main purposes of the upstream acquisition is, in fact, to acquire control of the downstream Code company voting rights, the meeting of the value test will be irrelevant).

11. The value of the assets is determined on a market capitalisation basis as at the date of the announcement of the upstream acquisition, but in advance of the announcement being made.

12. "Recognised exchanges" are New Zealand Exchange Limited and foreign exchanges in jurisdictions with a comparable level of investor protection to New Zealand. The Panel has identified the following foreign exchanges to be "recognised exchanges": the Australian Securities Exchange, 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, Singapore Exchange Limited, The Stock Exchange of Hong Kong Limited, Swiss Stock Exchange, Tokyo Stock Exchange, The Toronto Stock Exchange Inc.

Conditional exemption if the purpose test is not satisfied or no recognised exchange

13. If the purpose test is not satisfied or the upstream acquisition is of a target that is not listed on a recognised exchange, the Panel will most likely not grant an unconditional exemption.

14. However, the Panel will likely grant a conditional exemption in these circumstances. The exemption would be subject to the condition that the upstream acquirer elects to undertake one of the following compliance options:

    (a) sell down the upstream target's shareholding in the downstream Code company to 20% or less by no later than six months after the upstream acquisition becomes unconditional, and not exercise any more than 20% of the voting rights; or

    (b) make a follow-on offer for all of the shares in the downstream Code company no later than 30 days after the upstream acquisition becomes unconditional.

15. The election of the compliance option would have to be made no later than the later of, either:

    (a) 14 days after the follow-on offer price is determined by an independent expert (see below for details about the appointment and role of the expert); or

    (b) the day after the upstream acquisition becomes unconditional.

    A follow on offer must be made within 30 days of the upstream acquisition becoming unconditional. As a consequence, given the time to commission an independent expert and receive the valuation (see paragraph 22 *et seq* below) a request for appointment of the expert will need to be made well in advance of the day on which the upstream acquisition is to become unconditional. This is especially so for an upstream acquirer who may wish to know the follow-on price prior to making the election (see paragraph 26 below).

16. The election could be made at any time in advance of knowing the follow-on offer price, and before the upstream acquisition becomes unconditional.

Requirements of a sell down

17. If the sell down compliance option were elected the upstream acquirer would have to undertake to the Panel that it would ensure the upstream target divested the Code company shareholding so that the upstream acquirer would hold or control no more than 20% of the voting rights in the downstream Code company. The upstream acquirer would also have to undertake to the Panel that it would not exercise any voting rights in the Code company above the permitted 20% holding. The acquirer(s) of the divested

shares must themselves comply with the Code. That means, for example, that the upstream acquirer could not sell the shares to its associates unless the associates obtained the approval of the Code company shareholders, in accordance with rule 7(c) of the Code.

18. The exemption process is illustrated in the diagram at the end of this guidance note.

Requirements of a follow-on offer

19. If the follow-on offer compliance option were elected, the following conditions would apply:

    (a) the consideration for the follow-on offer must be cash (or include a cash alternative) and must be determined by an independent expert appointed by the Panel, on the basis of a valuation of the downstream Code company;

    (b) the offeror must pay the reasonable fees, costs and expenses of the independent expert;

    (c) the offeror must include in the offer document for the follow-on offer a copy of the independent expert's valuation; and

    (d) any other terms and conditions of the follow-on offer, included by the offeror in the offer document, must be in a form approved by the Panel.

20. The other terms and conditions of the follow-on offer that the Panel may approve, could include:

    (a) the usual conditions of takeover offers that are made pursuant to the Code (the Panel would need to have approved the wording of these and all other conditions);

    (b) that the requisite regulatory approvals (such as from the Overseas Investment Office or Commerce Commission) are obtained, and that the upstream acquirer will use its best endeavours in good faith to obtain all such approvals.

21. However, there could be no minimum acceptance condition included in the follow-on offer, other than that stipulated by rule 23 of the Code.

Appointment of an independent expert

22. The independent expert would be appointed by the Panel. The upstream acquirer would request that the Panel appoint an independent expert. The request must include a list of the advisers that the upstream acquirer has already received advice from in relation to the upstream acquisition and the resulting downstream acquisition. The upstream acquirer should not make any suggestions as to who it thinks would be appropriate for appointment by the Panel.

23. The Panel would then undertake a tender process whereby it would invite applications from experts that it considers suitable. The independent expert would be selected on

the basis of independence and appropriate qualifications and experience. The Panel would also take the expert's costs into account when making its selection.

24. The appointment process is consistent with the appointment process for an independent expert under rule 57 of the Code, which can be found on the Panel's website at http://www.takeovers.govt.nz/who/policy_appointments.htm.

25. Approximately four weeks should be allowed for the appointment process and a further two weeks for the valuation to be undertaken by the appointed expert.

26. A follow-on offer must be made within 30 days of the upstream acquisition becoming unconditional. Accordingly, it would be advisable for the upstream acquirer to approach the Panel for an exemption as early as possible in the acquisition (or pre-acquisition process). If a conditional exemption is granted to the upstream acquirer by the Panel, requiring the upstream acquirer to elect a compliance option (to sell down or to make a follow-on offer) it may be pragmatic to request the Panel to appoint an independent expert straight away. This would help to ensure that the compliance timeframes were able to be comfortably met.

Market disclosure

27. The market for shares in the downstream company must be adequately informed in relation to the upstream acquisition. Accordingly, at the same time that the upstream acquirer advises the Panel of its compliance option election (to either sell down or make a follow-on offer), it must announce its election to the market in a press release. If the follow-on offer compliance option is elected, the announcement must include full details of both the upstream and downstream acquisitions, including the timing and consideration for the acquisitions (the consideration for the downstream acquisition must be disclosed only if that consideration has been determined at the time of the announcement). If the downstream company is listed on a New Zealand registered exchange, an announcement must be made to the New Zealand registered exchange.

Compliance with Rule 64 of the Code – prohibition on misleading or deceptive conduct

28. Rule 64 of the Code prohibits misleading or deceptive conduct in relation to Code regulated transactions or events.[2]

29. Any statements, actions or other conduct by any person in relation to the downstream Code company would be subject to the rule 64 prohibition. Particular care should be taken over 'last and final statements'. For example, if the upstream acquirer were to state that it was going to elect a sell down compliance option, that would constitute a last and final statement under rule 64. The Panel would likely find that rule 64 had

[2] Rule 64 provides that:
(1) A person must not engage in conduct that is-
(a) conduct in relation to any transaction or event that is regulated by [the] Code; and
(b) misleading or deceptive or likely to mislead or deceive.
(2) A person must not engage in conduct that is-
(a) incidental or preliminary to a transaction or event that is or is likely to be regulated by [the] Code; and
(b) misleading or deceptive or likely to mislead or deceive.

been breached if the upstream acquirer did not then elect the sell down compliance option.

30. Likewise, shareholders, directors and any other person are subject to the rule 64 prohibition against misleading or deceptive conduct.

31. The Panel's policy on last and final statements is set out in Code Word 22 (available on the Panel's website under Publications).

Diagram of the exemption process for upstream acquisitions