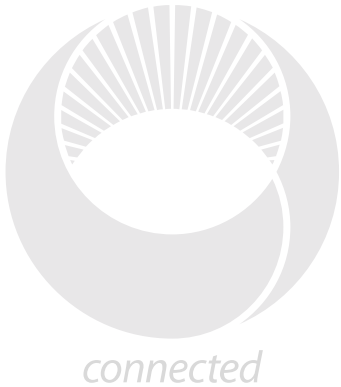


Takeovers Package

Finsia's proposal to reform Australia's takeovers regime to improve the market for corporate control, remove existing anomalies and protect the rights of minority shareholders

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1 Background: Overview of the Current Legislative Framework

What is a takeover?

A takeover is a transaction involving the acquisition of shares in a widely-held company where the number of shares involved is sufficient for the acquirer, if successful, to gain effective control of the company.

Takeovers are an integral part of the efficient operation of equity markets and the Australian economy as a whole. Takeovers (or the prospect of takeovers) provide benefits for shareholders, corporations and the economy generally, since they provide incentives for improved corporate efficiency and enhanced management discipline, leading ultimately to greater wealth creation¹.

Notwithstanding the general acceptance of the concept that takeovers are beneficial for economies, it is widely recognised around the world that some regulation of takeovers is required — principally to ensure that minorities' rights are preserved and that information available to shareholders and other stakeholders is adequate.

What are the general approaches to takeover regulation?

There are generally three descriptive types of takeover regulation²:

- **Mandatory bid regime:** If it is determined that a change of control has passed, a bid must be made by the new controller to all remaining shareholders on equal terms, eg. United Kingdom, Hong Kong, Singapore.
- **Threshold regime:** A threshold is set at which a change of control is deemed to occur, with purchases exceeding the threshold prohibited unless they are made pursuant to a takeover offer made to all shareholders, eg. Australia, New Zealand.
- **Notice and pause regime:** Various notices are required when certain shareholding levels are reached, followed by a period where no share purchases can be undertaken, eg. United States, Canada.

¹ For example, see *CLERP Proposals for Reform: Paper No. 4*. "Takeovers — Corporate control: a better environment for productive investment". April 1997. p11.

² Quigg, D (2003). *Guide to New Zealand's Takeovers Code*. Quigg Partners. Wellington.



What is the approach to takeover regulation in Australia?

The regulation of takeovers in Australia is primarily set out in Chapter 6 of the Corporations Act, with the underlying policy basis or objectives contained in section 602. Broadly, these objectives are:

- That takeovers take place in an efficient, competitive and informed market:
- That shareholders and directors:
 - know the identity of someone seeking to obtain control of their company
 - have reasonable time to consider any change of control proposal
 - are given sufficient information to assess a change of control proposal, and
- That shareholders are given a reasonable and equal opportunity to participate in benefits arising from the proposal (the so-called “Eggleston Principles”).

Chapter 6 comprises relatively complex “black letter law” setting out in detail procedures to be followed by bidders and target company directors, disclosure requirements for the bidder and target, and procedures for compulsorily acquiring remaining shares following an offer. It also provides, however, for the Takeovers Panel to resolve takeover disputes, by applying broad powers based on the application of the Eggleston Principles. The Takeovers Panel is a peer-based panel that applies wide principles to achieve a relatively low-cost and commonsense approach to disputation arising from complex law.

Since the introduction of uniform takeover regulation effective 1981, there have been many developments and improvements to the law, most noticeably the CLERP reforms effective 2000, which introduced the Takeovers Panel as the sole adjudicator in takeover disputes³. In general, this development has had a profound impact on the conduct of takeovers, with the cost and time delays in takeover disputes generally falling substantially.

Notwithstanding the reform that has occurred in recent years, Finsia believes several areas of the law can be further improved while preserving the integrity and effectiveness of the current regulatory framework. Indeed, some of the reform recommended by Finsia is feasible only because of the effectiveness of the CLERP reforms.

³ The provisions of the CLERP Act, effective 13 March 2000, give the Panel an expanded role from that which it had had prior to CLERP. Section 659AA of the Act describes the post-CLERP Panel as the primary dispute resolution forum for takeover bids during the lifetime of those bids.



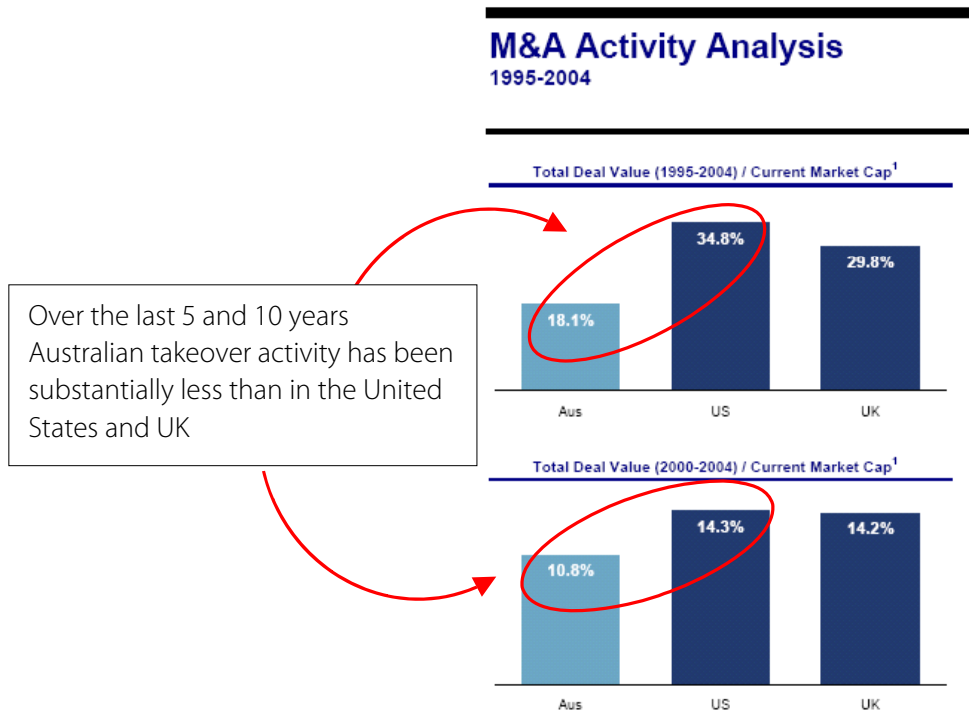
Why is there need for a change?

Finsia believes that there are a number of aspects of Australia's takeover regulation, which could be reformed to further facilitate takeovers, and at the same time protecting minority shareholders who may be disadvantaged by provisions of the current legislation. In Finsia's view, the current Australian law, while substantially improved over recent years, still contains elements that are unnecessary and artificial impediments to a free market for corporate control.

While it is difficult to assess with any certainty the extent to which any regulation of a particular activity inhibits that activity, it is interesting to note that the level of takeovers in Australia — notwithstanding the recent relatively high level of activity — is still generally less than that of the most comparable markets, such as the United States and United Kingdom.

While Australian takeover activity has been more comparable with the United States in recent years, this has been during a period of historically low activity in the United States. To illustrate, the following chart shows the level of takeover activity over the last 10 years in Australia compared to the United States, relative to market capitalisation.

M&A activity as a percentage of market capitalisation



Source: Thomson Financial Securities Data

In addition to Finsia's position that some aspects of Australian takeover regulation is an unnecessary constraint on takeover activity, Finsia is mindful of public criticisms made of the takeover process in some recent large transactions in Australia. These criticisms have come from both large institutions and bodies representing smaller shareholders. Finsia proposals seek to address some of these concerns.

Finsia believes that its proposals for reform would further facilitate takeover activity in Australia and would remove a number of anomalies that create inequitable treatment in takeover transactions. Finsia believes its proposals for reform would achieve this while preserving (and indeed furthering) the conceptual foundations upon which Australian takeover regulation is based; the Eggleston Principles of equal and fair treatment.

2 Finsia's Proposals for Reform

2.1 Increasing the takeover threshold from 20% to 30%, in conjunction with abolishing the "3% creep in six months" rule

Finsia proposes that the takeover threshold should be increased from 20% to 30%, in conjunction with abolishing the exemption known as the "3% creep in six months" rule. Finsia considers that an increase in the threshold would facilitate more efficient takeover activity without compromising the principles underlying the law. Finsia also believes that allowing a party to increase its voting power in a public company over time without making a takeover offer compromises the concept of equality of opportunity for all shareholders.

2.1.1 Increase threshold to 30%

Section 606 of the Corporations Act prohibits the acquisition of relevant interests in voting shares where a transaction would mean that a person's voting power would exceed 20% — the "takeover threshold". The takeover threshold concept provides a level above which control is achieved to such extent that minority shareholders should be protected either by receiving an offer for their shares or otherwise approving the move to that level.

Section 606 originated in section 11 of the Companies (Acquisition of Shares) Act 1980. Section 11 was based on the principle that a single person or connected group should not, by acquisition, achieve control over more than 20% of a class of a company's voting shares without:

- affording to all other shareholders of the class equal opportunities to dispose of their shares; and
- complying with disclosure and procedural requirements.

The Explanatory Memorandum to the Companies (Acquisition of Shares) Bill stated that the "20% threshold is considered appropriate as in most cases it would fall short of the figure that could be regarded as the point beyond which control can be said to have passed." The basis of the code was that control should not pass without the safeguards under the code applying.

Finsia believes that 20% was an appropriate threshold for introduction of the new takeovers law 2 ½ decades ago. However, the law is now well entrenched in the Australian market and international market standards have moved on. Finsia contends that a 30% takeover threshold is a more accurate reflection of the level above which control in a widely held public company may pass.

Due to the sparsity of academic discussion concerning the impact of Australia's takeovers regime, Finsia has commissioned independent research from Martin Bugeia, Lecturer at the University of Sydney Business School, and Raymond da Silva Rosa, Associate Professor at the University of Western Australia Business School and Research Director (Equities) of SIRCA, to determine what threshold level allows effective control to pass and whether increasing the takeover threshold would adversely impact on the rights of minority shareholders. The Appendix to this proposal provides a copy of their research report ***Raising the takeover threshold in Australia: Issues and Evidence***.



The study concluded that, based on the capital structures of Australian listed companies, 30% is an appropriate level for measuring the threshold for change of control. The research report stated “a 30% takeover threshold will bring Australia in line with countries that have adopted an equal opportunity rule, thus facilitating harmonisation of its takeover regulation ... The UK has a higher incidence of takeover activity and higher takeover premiums than Australia, demonstrating that the increase in threshold is compatible with both greater contestability of corporate control and higher return to target firm shareholders. Greater contestability of corporate control is desirable because it promotes economic adaptability and efficiency.”

One concern with a 30% takeover threshold is that it may facilitate de facto control passing to an acquirer below that level. However, the research report reveals that target firms have, on average, higher ownership concentration than other firms (even after controlling for size), indicating acquirers do not seek to achieve control on the cheap by acquiring block holdings in diffusely owned firms. Higher ownership concentration among target firms indicates acquirers value the additional certainty of outcome delivered by having to negotiate with fewer shareholders. An increase in the takeover threshold from 20% to 30% would deliver greater certainty by allowing acquirers to achieve a greater toehold in the target before launching a bid. Safeguards for target shareholders include the mandatory substantial shareholder disclosure requirements, which are effective in ensuring investors are kept informed about the possibility of a takeover bid eventuating.

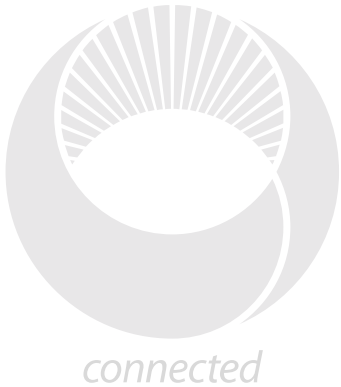
The research report includes evidence from Australia and the United Kingdom to demonstrate that concerns that the takeover premia may fall as a result of increasing the threshold to 30% and that effective control may be possible at this level without paying an appropriate premium are unsubstantiated.

Australia is one of the few remaining jurisdictions with a 20% takeover threshold. The takeover thresholds in other major marketplaces are as follows:

Netherlands	50%	Singapore	30%
France	33%	Hong Kong	30%
Switzerland	33%	Sweden	30%
Malaysia	33%	Spain	25%
United Kingdom	30%	Thailand	25%
Germany	30%	New Zealand	20%
Italy	30%	Canada	20%
Ireland	30%		

It should be noted that the United States market operates without a formal takeover threshold. It is also interesting to note the recent changes in comparable thresholds:

- Singapore increased its threshold from 25% to 30% (end 2001)
- Hong Kong decreased its threshold from 35% to 30% (end 2001)
- Germany adopted a 30% threshold (end 2001)
- Sweden decreased its threshold from 40% to 30% (end 2003)



Increasing the takeover threshold would have a number of potential benefits:

- Freeing up the operation of the equity market from an artificial constraint which prevents holdings of between 20% and 30% without a takeover offer being made, notwithstanding that control has not changed at these levels;
- Facilitating takeovers by permitting higher pre-bid stakes being acquired by potential bidders; and
- Bringing Australian takeovers law into line with major overseas jurisdictions, which generally provide for takeover thresholds exceeding 20%.

The primary argument against raising the takeover threshold is that it would enable bidders to move to the higher threshold thereby inhibiting alternative bidders.

However, it is Finsia's view that the larger number of takeovers that is likely to occur because of the greater certainty provided to bidders would offset any detriment. The benefit of increased takeovers activity is shared by shareholders of both bidders and target companies and flows onto Australia's capital markets and the economy as a whole. Finsia further notes that it is not an underlying principle of Australia's regulation that potential alternative bidders be given protection by making the offer process more uncertain for primary bidders.

2.1.2 Abolishing the "3% creep" rule

Finsia believes that the proposal to increase the takeover threshold to 30% must be accompanied by the abolition of the "3% creep in six months" rule. This rule, introduced to provide flexibility in the context of the low 20% threshold, in practice permits breaches of the Eggleston Principles by enabling control to change without an offer being made to all shareholders. It also allows control to change following an inadequate offer.

Broadly speaking, section 611(9) permits acquisitions of up to 3% every six months, without limit. Acquisitions pursuant to section 611(9) are otherwise unregulated, with no prior notification or any procedure to make them available to shareholders generally.

Finsia believes the "3% creep in six months" rule can be (and has been) used to effectively thwart the Eggleston Principles in a number of ways:

- A party can simply acquire control over time by acquiring 20% initially and then building their holding utilising the "3% creep in six months" rule as quickly as possible. In this way, a realistic control level (say, above 40%) can be achieved in 3 ½ years.
- Potential bidders are able to make offers below the level that otherwise would be sufficient to gain control: for example, an bidder can make a low offer, confident that in the event that it doesn't achieve control, it can "creep" to control relatively quickly. If the bidder were to achieve say 35%, it knows that effective control can be achieved within a year (assuming that a 40%+ holding delivers effective control). This potential for creeping control also places the bidder in a negotiating advantage with the target board. It enables the bidder to use the threat of impending creep acquisitions to demand greater board representation.

When a large shareholder entrenches control through creep acquisitions, purchases are made above the prevailing market price but the offer is usually only made to selected shareholders. In a number of cases, large shareholders utilising the creep rule have run above-market tenders over a short time period (say over a few hours) that are only available to institutional shareholders.

Removing the "3% creep in six months" rule would bring Australia into line with most major overseas jurisdictions including:

- United Kingdom, which in the early 1990s reduced its creep provision from 2% to 1% before abolishing it altogether in 1998;
- Hong Kong, which reduced its creep provision from 5% to 2% in any 12-month period; and
- Singapore, which reduced the creep provision from 3% in any 12-month period to 1% in six months.

A 5% in any 12-month period is generally applied in Canada. New Zealand has a 5% creep provision restricted to acquisitions with a holder that already has a shareholding above 50%, thus eliminating some of the negatives of creeping purchases.

The principal arguments in favour of the “3% creep in six months” rule have revolved around ensuring flexibility and promoting liquidity. However, in the United Kingdom, for example, there have been very few practical problems experienced as a result of the reduction and eventual abolition of creep provisions.

Finsia recommendation

Finsia recommends that the takeover threshold should be increased to 30%, coupled with the abolition of the “3% creep in six months” rule.



2.2 Facilitating pre-bid acceptances by introducing a Pre-bid Commitment Rule (PCR)

Finsia proposes that a “Pre-bid Commitment Rule” (PCR) be adopted to facilitate the takeover of companies with a single large shareholder. By revising the earlier CLERP concept of a mandatory bid rule, Finsia believes the PCR would allow greater certainty for both bidders and target companies, providing a framework that promotes greater takeover activity without compromising the objectives of Australian takeovers regulation.

It should be noted that companies with a single large shareholder form a minority of listed companies in Australia and are often smaller companies where the large shareholding represents an entrepreneur’s or founder’s remaining holding following a public listing.

What deficiencies in the law is Finsia seeking to address?

Broadly speaking, the present law’s shortcomings are:

- The large shareholder’s ability to sell its asset is significantly constrained by its inability to offer a potential purchaser certainty. That is, the shareholder cannot promise to sell its shareholding to a potential acquirer, as this promise would constitute an illegal acquisition of a relevant interest in the shares by the acquirer.
- Because the acquirer is not permitted to buy beyond the takeover threshold (but is free to buy, largely without restriction, up to that level) it is common for a transaction between an acquirer and a controlling single shareholder to be structured as an unconditional cash acquisition of 20% (or 15% for a foreign acquirer) followed by a conditional offer for the remaining shares (being the controlling shareholder’s remaining shares, and the minority shareholders’ holdings). In this way, the controlling shareholder is often advantaged relative to the minority shareholders, because the controlling shareholder is able to negotiate to sell a large proportion of its holding unconditionally, while all minority shareholders are offered a conditional offer (albeit at the same price) which may never become unconditional.
- The law is out of step with nearly every other major market, which permit the acquisition of shares beyond the takeover threshold, on the proviso that a follow-on offer is made to minority shareholders.

The initial CLERP reforms, seeking to address these shortcomings, included a proposal for a Mandatory Bid Rule (MBR). The MBR would have facilitated changes in corporate control by allowing acquisitions that would exceed the 20% takeover threshold provided that the acquisition was immediately followed by the announcement of a full unconditional cash takeover bid. This would have provided bidders with an additional mechanism to acquire control and was designed to remove an impediment to bidders without compromising equal opportunity for shareholders. Furthermore, the proposed MBR would have reduced the costs of making a takeover bid and it was reasonable to assume in a competitive market that some of these cost savings would flow to target shareholders⁴.

⁴ CLERP Bill Explanatory Memorandum, 1998.



However, the proposed MBR was somewhat cumbersome (in that it provided only for unconditional cash offers) and in many ways would have been difficult to utilise in practice. Ultimately, the proposed MBR was removed from the Bill in the Senate. Subsequently the Parliamentary Joint Committee on Corporations and Securities (PJCCS) recommended that the rule should be reconsidered in the future when the effectiveness of the CLERP reforms could be assessed.

Since the Senate rejected the MBR, the Takeovers Panel has proposed an alternative called the “Undertaking MBR” (UMBR). The UMBR proposal is essentially similar to the MBR proposal, but would provide that the pre-bid acceptance must be conditional upon no superior proposal being made for the target company. This proposal would be superior to the current law in that the bidder would be certain that its bid would be accepted by the major shareholder, subject only to a higher bid not emerging ie. the proposal eliminates the risk for the bidder that a major shareholder decides not to sell at all.

However, the UMBR proposal does not give certainty to the bidder in that it may make an offer, disclosing its position publicly, and still face the risk that its bid may be unsuccessful. Even though the Takeovers Panel proposal offers a sensible reform of the present law, it is not in fact an alternative to the MBR because it does not provide bidders certainty — the central plank of the MBR concept.

What is Finsia’s proposed approach?

Finsia has developed a simpler, fairer and more effective alternative to the MBR, which it refers to as the “Pre-bid Commitment Rule” (PCR). The proposed PCR would enable an bidder to acquire more than the designated takeover threshold from a single shareholder provided the same offer is made to all other shareholders.

The proposed PCR would allow a bidder to enter into an off-market irrevocable pre-bid acceptance agreement with a single major selling shareholder, conditional or otherwise, provided an identical public offer were made for the remaining shares. If the offer contained conditions, they would have to be satisfied in full before the agreement can come into effect and consideration is provided. At that time the offer is made to all shareholders on the same basis. The PCR would be available for cash, scrip or combined bids.

Finsia proposes that the PCR would only permit an agreement with a single major shareholder (with provisions permitting multiple holdings of one person to be aggregated for this purpose), and would require acceptance into the bid of the entire holding of that shareholder. It is important to the concept of the PCR that it would only be capable of use by a single controlling shareholder, and only for that shareholder’s entire holding. Accordingly, safeguard provisions would prevent the creation of a controlling shareholding merely for the purpose of using the PCR (using a time test; for example, the controlling shareholder would have to have had a relevant interest in all of the shares in the holding for say, six months). Furthermore, the PCR would have to be utilised for the entire parcel so that shares in the controlling holding could only be acquired by the bidder pursuant to the PCR offer.



Finsia contends that its PCR concept provides a number of improvements in comparison with the current law:

- It would significantly assist the acquisition of public companies with a major shareholder for which the present law imposes an artificial constraint;
- It would bring Australia's takeover law into line with other jurisdictions, none of which impose Australia's current restriction;
- When the PCR is utilised, minority shareholders would receive an identical offer to the controlling shareholder, unlike the present situation where controlling shareholders often sell a major part of their holdings (up to the takeover threshold) unconditionally.

The PCR would be voluntary, and as such an acquirer could choose to make an offer for a company with a controlling shareholder utilising the current rules if it so decided.

The major objection to the previous MBR proposal was that it could lead to lower offers for all shareholders because a binding agreement by the vendor controlling shareholder would prevent the emergence of counter-bidders (and therefore an auction). Potentially, Finsia's PCR proposal is open to the same criticism, but this is countered on the basis of the following reasons:

- **Equal opportunity:** Minority shareholders under the PCR would be offered identical terms for their shares as the controlling shareholder, therefore meeting the fundamental Eggleston Principles. Importantly, if the PCR offers' conditions were not met then neither the controlling shareholder nor the minority shareholders would receive the benefits of the offer (unlike the present situation). Accordingly, it will be in the interests of the controlling shareholder to negotiate favourable offer conditionality with the acquirer, for the benefit of all shareholders.
- **Maximum price:** In the view of Finsia, commercially driven parties will always seek to maximise the price of any asset they are seeking to divest. Accordingly, controlling shareholders will always seek the highest offer before agreeing to utilise the PCR.

It has been argued that a distressed seller may (in its urgency to sell) be prepared to accept a less-than-full price for their shares. In Finsia's experience, this is not the case; indeed, vendors in financial difficulty are often controlled by receivers or liquidators skilled in achieving high prices for assets. In any event, Finsia believes that the distressed seller scenario occurs in a small number of cases and the remote possibility that minority shareholders are disadvantaged by having a takeover price set by a distressed majority seller should not inhibit this valuable reform.

- **Certainty:** If a controlling shareholder is not satisfied it is achieving the optimal terms for its shares (and wishes to sell its shares under a procedure which permits counter-bidders) it will not avail itself of the PCR provisions.

Even though Finsia believes that controlling shareholders will always ensure that they are selling their shares on optimal terms (and that, accordingly, minority shareholders will be offered the optimal terms for their shares), it notes that the Eggleston Principles do not mandate that there should be the opportunity for a public auction whenever a controlling shareholder divests its shares. However, the Eggleston Principles do require that minority shareholders be provided equal opportunity to share in the benefits of a takeover. The PCR proposal would meet this principle more completely than the present law. Finsia believes that its PCR proposal is a sensible improvement over the earlier MBR concept and provides benefits for acquirers, controlling shareholders and minority shareholders.

Finsia recommendation

Finsia recommends that the law be amended to contain a Pre-bid Commitment Rule (PCR) to facilitate the takeover of companies with a single large shareholder.



2.3 Removing the inconsistencies in the prohibition on collateral benefits

Finsia believes that section 623 of the Corporations Act preventing the provision by a bidder of collateral benefits to particular shareholders is significantly flawed and should be revised.

The concept of outlawing collateral benefits is straightforward; it is a fundamental premise of the Eggleston Principles that all shareholders should equally enjoy the benefits of a takeover offer. It follows that where a bidder transfers value (whether this transfer of value is in cash, or some other arrangement such as the sale of an asset for below real value) to certain shareholders to induce their acceptance, and where this value transfer is not provided to all shareholders, that the equality of opportunity principle has been breached. In either case, it should have been possible to restructure the value transfer to make it available equally to all shareholders.

The concept of “equal opportunity” in the Eggleston Principles is clear. As an example, if a particular shareholder requires \$4.00 per share to accept a takeover offer, and other shareholders would be prepared to accept \$3.50, it should not be open to the bidder to pay the first shareholder \$4.00 and the remainder \$3.50. The bidder is required to pay a single price that is acceptable to enough shareholders for the bidder’s minimum acceptance conditions to be met.

Another example where it may be extremely difficult to conclude that benefits are not going to flow to a shareholder would be where that shareholder only agrees to sell its shares on the basis of a contract that it has with the target company being amended post successful completion of the offer

On the other hand, it is common in takeovers for situations to emerge where it is desirable for a particular shareholder to be treated differently from other shareholders because of their unique circumstances. Such differential treatment (so long as it does not transfer value to the shareholder) should not be prevented. For example, a majority shareholder in a company may have extended shareholder loans to that company. In this case, the only way for a bidder to make an offer which would benefit all shareholders may be to arrange for the shareholder debt to be repaid. In these circumstances, as long as the debt repayment is on arm’s length terms (that is, it does not confer a transfer of value to the particular shareholder) it should not be proscribed. In fact, the contrary is true; if the law prevents such a transaction, it may be preventing an offer that would benefit all shareholders.

Another example is a shareholder that will only sell its shares if it is able to acquire a particular asset owned by the target. In this case, preventing the bidder from agreeing to sell that asset to the shareholder after the offer is completed may result in no offer being made to all shareholders. It is Finsia’s view that such an agreement, even if it is of advantage to the particular shareholder which induces that shareholder to accept the offer, should not be prohibited so long as the price to be paid for the asset is at arm’s length (and therefore the sale of the asset does not represent a transfer of value to the particular shareholder which would otherwise be available to all shareholders).

It is also Finsia’s view that section 623 is flawed in that it has the capacity to proscribe transactions that do not breach the Eggleston Principles, while potentially permitting transactions that would represent fundamental breaches of the principle. Section 623 as it presently stands only prohibits the provision of benefits during the offer period; therefore it does not apply before the offer, arguably the most obvious time period for egregious breaches of equal opportunity. For example a bidder may wish to encourage a particular shareholder to accept its offer by transferring value to that shareholder — say, by selling an asset cheaply. In order for this transaction to be legal, it simply has to be agreed before the offer (which would be the most logical time to do so).

While it is arguable that such a transaction would give rise to the operation of section 621(3) (that is, the 4-month highest price rule), Finsia contends that it is not certain that the words of 621(3) adequately capture the provision of a benefit provided through a side transaction. Furthermore, given the prospect that side deals can give rise to very significant breaches of the principle of equal opportunity, there does not seem to be any logic in restricting the prohibition to any particular time period.

Finsia notes that the Takeovers Panel released an Issues Paper on Collateral Benefits on 9 November 2005. The concept of a 'fair price' is raised by the Panel along with questions as to how a fair price should be determined and in what circumstances a transaction may be unacceptable. Finsia submits that limiting 'benefits' in section 623 to non-arm's length transactions will reduce this uncertainty.

Finsia recommendations

Finsia recommends that section 623 be amended as follows:

- "Benefit" be defined to include only acts that are not at arm's length value (that is, acts have the potential to result in a transfer of value from the bidder or potential bidder to a target shareholder);
- Benefits given by a bidder to a shareholder of a target company in order to induce acceptance of the bid be prohibited at any time (before, during or following a bid).



2.4 Abolishing the prohibition on escalator clauses

Section 622 of the Corporations Act prohibits “escalation agreements”; that is, agreements with target shareholders whereby the price of shares acquired before an offer will be increased depending on the price of the subsequent offer.

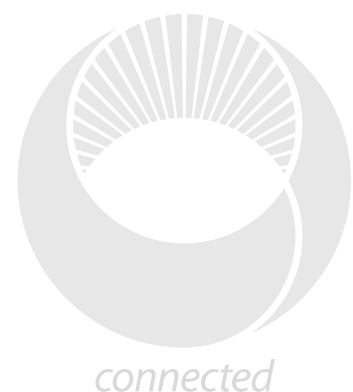
Escalation agreements were prohibited as part of the legislative response to “pro rata partial” offers, which were widely viewed as being coercive (as distinct from “proportional bids”, which do not have the same coercive effect). Pro-rata offers were, however, prohibited by specific sections of the law in 1986, and Finsia believes that the prohibition on escalation agreements is no longer valid.

It should also be noted that section 622 impacts the methodology that a person acquires the shares below the takeover threshold, which at a policy level should be unregulated.

Escalation agreements can, in certain circumstances, facilitate the assembly of a pre-bid stake in a target company, and assist the bidder in the process of establishing a bid. For this reason, Finsia believes that the prohibition should be removed.

Finsia recommendation

Finsia recommends that section 622 is now an anachronism (prohibiting an activity for which there is no mischief) and therefore should be repealed.



2.5 Removing the inconsistencies between the regulation of schemes of arrangement and takeovers

Background to Finsia's views

The Corporations Act essentially allows the acquisition of control of a public company to be achieved in one of two ways:

- A person making a takeover offer for a target company, pursuant to Chapter 6 of the Corporations Act; or
- A target company entering into a scheme of arrangement, pursuant to Chapter 5 of the Corporations Act.

Finsia is concerned that over time, market practice, together with a pattern of judicial decisions, has led to a two-tiered regulatory framework for acquisitions of public companies. This framework permits a person who is seeking to gain control of a public company to carry out “regulatory arbitrage”; in other words, to choose between legislative approaches to the advantage of the bidder without regard to the rights and entitlements of shareholders.

In particular, Finsia believes that the current usage of schemes of arrangements, under the laws that govern them, has resulted in shareholders being deprived of the protection, which legislators intended they should have when takeover laws were formulated.

Schemes of arrangement derived from traditional English law, and the Australian law (section 411) remains similar to the United Kingdom provisions. The law was developed before takeovers, as they are now understood, had developed; indeed the language doesn't suggest that the law's authors contemplated their current usage (section 411 refers to where “a compromise or arrangement is proposed between a company and its creditors or a company and its members”).

Notwithstanding the law's derivation or intended purpose, schemes of arrangement have become a common way of effecting a change-of-control transaction. In the last 5 years, nearly 40% of all large (greater than \$1billion) change-of-control transactions have been carried out as schemes of arrangement.

Importantly, the nature of schemes of arrangement has changed markedly. Until relatively recently, schemes of arrangement were used predominantly in the circumstances of:

- Complex transactions which couldn't be achieved by way of takeover; and
- 'Agreed mergers', typically between companies of similar size, and often with lower premiums than hostile or contested takeovers.

However, more recently, change-of-control transactions in Australia have tended towards the American model, where transactions that are 'hostile' or at least 'unsolicited' are achieved by the potential bidder putting the target into a 'bear hug'. In a 'bear hug' the bidder induces the target to agree to recommend to shareholders the company's acquisition with the sanction that if the target board doesn't recommend the offer, the board's refusal will be made public and its decision will be subject to the public scrutiny of shareholders and market commentators. Boards' sensitivity to public pressure has been heightened by much greater shareholder activism and higher standards of corporate governance and directors' duties.

The result of this trend has been that change-of-control transactions, which previously would have been effected as takeovers, can now be achieved by schemes of arrangement.

In summary, a scheme of arrangement (a legal mechanism never intended for change-of-control transactions in the first place) has developed from being a method of achieving a 'true merger' (or a complex reconstruction) into a viable alternative for a Chapter 6 Takeover.

It should be noted that legislators recognised the problems inherent in the potential duplication of takeover laws by inserting sub-section 411(17) into section 411. This sub-section requires that a court cannot approve a scheme of arrangement unless:

- it is satisfied that the compromise or arrangement has not been proposed for the purpose of enabling any person to avoid the operation of any of the provisions of Chapter 6, or
- ASIC provides a no-objection statement.

This sub-section has been rendered largely ineffective by successive court decisions, and ASIC's current practice is now to issue no-objection statements routinely, subject to it being satisfied that the Eggleston Principles are being broadly met by the scheme of arrangement.

What problems in the law is Finsia seeking to address?

As mentioned above, there are now effectively two separate mechanisms under the Corporations Act for a change-of-control transaction to be effected — a Chapter 5 Scheme of arrangement or a Chapter 6 Takeover.

While Finsia is of the view that it is necessary for both schemes of arrangement and takeovers to be available for change-of-control transactions, the present regime should be revised so that significant anomalies between the approaches and the availability of 'regulatory arbitrage' (that is, the choice for bidders between the two options based on the best regulatory outcome) can be removed from the law.

The main anomalies between the two approaches are set out below.

Shareholders participating in Chapter 5 schemes of arrangement are not afforded a number of the protections contained in Chapter 6. These include:

- the prohibition on discriminatory conditions (section 627),
- the four month minimum price rule (section 621(3)),
- the prohibition on the provision of collateral benefits (section 623), and
- the automatic offer increase provision (section 651A, which automatically increases an offer to the level of cash purchases made outside the offer, if the price of these purchases is higher than the offer).

While the circumstances where an expert report is required (where the bidder holds more than 30% of the target or where there are common directors between the bidder and the target) are similar as between takeovers and schemes of arrangement, the prescribed test to be applied by the expert is different. In a takeover, the expert must determine whether the offer is 'fair and reasonable', whereas, in a scheme of arrangement, the expert must determine whether the offer is 'in the best interest' of the shareholders. While market participants have sought to resolve the meaning of 'in the best interest' relative to 'fair and reasonable', Finsia believes that there remains a lack of clarity between the terms and a strong likelihood of shareholder confusion as to what the two terms mean.

The provisions relating to compulsory acquisition for takeovers (ie. the levels of acceptance which lead to the takeover becoming binding on all shareholders) and the approval levels for schemes of arrangement (which also lead to the terms of the scheme becoming binding on all shareholders) are also significantly different.

In essence, a bidder can achieve compulsory acquisition in a chapter 6 takeover where:

- If the bidder starts the offer with less than 60% of the target, by achieving a holding of the target of 90%; or
- If the bidder starts the offer with more than 60% of the target, by gaining acceptances in relation to at least 75% of shares under offer.

By contrast, a scheme of arrangement becomes effective if 75% of shares voted at the meeting are voted in favour of the scheme, and more than 50% of shareholders by number vote in favour of the scheme (“50% head count test”). Importantly, these thresholds relate only to shares voted and shareholders that attend the shareholder meeting, either in person or by proxy.

The effect of these provisions is that the compulsory acquisition threshold is generally much lower for schemes of arrangement than it is for takeovers. In Finsia’s view, this difference is difficult to justify; presumably, this matter was considered carefully when the takeover threshold was set, given that compulsory acquisition deals with the important principle of forcible divestment.

Clearly, there are situations where forcible divestment involves significant hardship for a shareholder and can only be justified where an overwhelming majority support the transaction, and the greater good is served by permitting the bidder to force completion. In these circumstances, Finsia believes that the significant difference between the thresholds for takeover and schemes (given that, as argued above, these two methodologies are effectively alternative approaches to achieve the same outcome) is a significant and unjustifiable anomaly.

Notwithstanding the specific regulatory differences between Chapter 5 schemes of arrangement and Chapter 6 takeovers discussed above, the primary difference is that the underpinnings of takeover law — the Eggleston Principles — are absent from the regulation of schemes.

Finsia believes that the Eggleston Principles, together with the concept that takeovers should take place in an “efficient, competitive and informed market” form the best basis for all change-of-control transactions to take place. It is notable, in prescribing the concepts for Chapter 6 takeovers (section 602), the law provides that the purposes of Chapter 6 are to ensure that these principles apply to the acquisition of control in relation to widely-held companies.

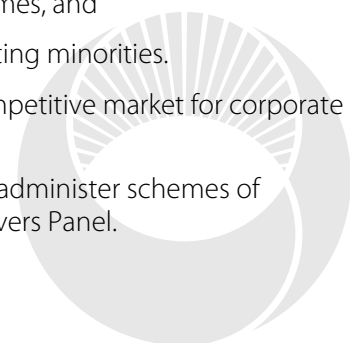
While ASIC, through Policy Statement 60, seeks to incorporate the Eggleston Principles into schemes of arrangement by making compliance with the principles a condition of it granting a section 411(17) no-objection letter, section 411(17) does not make the granting of such a letter a pre-condition for court approval of a scheme. Accordingly, the current law does not require that the Eggleston Principles apply to schemes of arrangement, and indeed the courts have stated that the Eggleston Principles may not always be applicable to schemes.

In summary, Finsia is strongly of the view that the current situation where schemes of arrangement are being used as an alternative to takeovers for change-of-control transactions is anomalous for the following reasons:

- There is no application of the Eggleston Principles to schemes;
- There is a lack of shareholder protection provisions in Chapter 5 schemes, and
- There are differing thresholds for compulsory acquisition from dissenting minorities.

These distinctions do not serve any useful purpose in an efficient and competitive market for corporate control.

Finsia notes that the courts, assisted by the ASIC section 411(17) opinion, administer schemes of arrangement, whereas takeovers are administered by ASIC and the Takeovers Panel.



In the case of a scheme of arrangement there are two compulsory court hearings during the course of the scheme. In the case of a takeover, the Takeovers Panel plays a role only where a party makes a complaint. There are a range of views on the appropriate jurisdiction to administer schemes and we would be pleased to participate in any discussion on the respective merits of the courts and the Takeovers Panel, noting that the Takeovers Panel has developed into an effective and expert forum for deliberating on change of control transactions.

What is Finsia's proposed approach?

Finsia is of the view that the anomalous laws pertaining to takeovers and schemes of arrangement cannot be justified in the context of an efficient and competitive market. However, while the case for reform in this area can be made strongly with relative ease, the method of achieving reform is more problematic.

In Finsia's view, the primary issue to consider is: should schemes of arrangement remain as an alternative methodology for effectively achieving a takeover, or should they be restricted (as the wording of section 411(17) suggests was the intention of the legislature) to transactions not achievable by way of takeover?

Finsia's view is that it would be preferable to restrict schemes of arrangement to:

- Complex transactions which cannot reasonably be effected by way of Chapter 6 Takeover; and
- True 'mergers of equals', defined broadly as mergers by way of scrip for scrip, or predominately scrip for scrip, between companies of similar size and where control of the new company going forward is shared between the merger partners.

If this approach were to be taken, it could be achieved by a new section 411(17), which could incorporate the above concepts.

Finsia recommendations

Irrespective of whether the role of schemes of arrangement is restricted as suggested, Finsia believes that the anomalies in the law need to be removed.

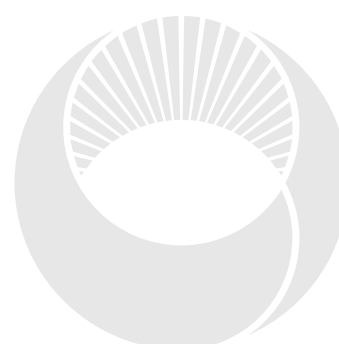
Accordingly, Finsia recommends that:

1. The Eggleston Principles be formally included in Chapter 5 as a basis for all schemes of arrangements where they constitute change-of-control transactions. Finsia believes this will provide a consistent regulatory framework for all change-of-control transactions.
2. Chapter 5 be reviewed thoroughly, such as to incorporate all relevant disclosure requirements and protections that are currently provided to shareholders in Chapter 6. Finsia believes this would reduce "regulatory arbitrage" between takeovers and schemes. Part of the reason for reforming the provisions is to ensure a single prescribed test for independent experts' reports is applied. Finsia considers that "fair and reasonable" as distinct concepts provides sufficient flexibility to allow quantitative and qualitative assessment for all transaction-types .
3. The thresholds for affecting a scheme of arrangement are brought into line with the compulsory acquisition thresholds in Chapter 6. Finsia notes that this proposal would still be different from takeovers in that it would apply only to shares voted at the meeting (as distinct from a Chapter 6 compulsory acquisition, which is based on the target company's entire

capital). However, Finsia believes that this proposal would reduce considerably the advantage that schemes may have over takeovers, in relation to forcible divestment of dissenting minorities' shares. Our proposal is that the scheme resolution would fail if more than 10% of the shares on issue in a relevant class of shares are voted against the resolution.

4. The present "50% head count" test is illogical in that it is at odds with the fundamental notion of corporate democracy (ie. one vote per share). The head count test for approval of schemes of arrangement should therefore be removed.

Finsia recognises that there is debate across industry concerning schemes of arrangement and some market participants favour their retention as 'takeover alternatives'. Accordingly, Finsia believes that it is appropriate for the Government to consider public perspectives on this matter, perhaps through the Parliamentary committee process.



2.6 Ensuring that the underwriting exemption is not being exploited to circumvent the takeovers restrictions

Finsia believes that the underwriting exemptions contained in sections 611(10) and 611(13) have been used to achieve acquisitions of shares by major shareholders where the primary intention of the underwriter has been to achieve or cement control rather than provide financial accommodation to the company concerned. In these circumstances, Finsia believes the Eggleston Principles have been compromised.

Section 611(10) provides an exception to the takeovers threshold for acquisitions by underwriters or sub-underwriters resulting from rights issues. Section 611(13) sets out an exemption from the takeovers threshold for acquisitions by underwriters or sub-underwriters which result from issues pursuant to disclosure documents (for example, placements). These provisions enable a party to gain control of a company if the party underwrites an issue and acquires the shortfall shares.

Finsia notes that most other jurisdictions, including the UK, Hong Kong and New Zealand, do not provide any exception for rights issues or other underwriting situations. However, Finsia considers that it would be to the detriment of Australia's capital markets — particularly for "small cap" companies which from time to time need to raise funds quickly and through the equity markets — to remove the exceptions altogether.

Finsia is concerned, however, that the exceptions can readily be abused; for example, by structuring a rights issue where a substantial shareholder underwrites it, and prices it so that it is unappealing to other shareholders, thus resulting in a large number of rights not being taken up and with the substantial shareholder having access to these shares. This transaction may then pass effective control to the major shareholder. Finsia considers this provision compromises the principle of equality of opportunity for shareholders to participate in the market for corporate control.

Finsia recommendation

Finsia believes that the underwriting exemption was included in the Corporations Act solely to permit inadvertent acquisitions of shares beyond the takeover threshold where the full purpose of the underwriting was to provide financial accommodation to the company. Finsia therefore believes that the problem that emerges with sections 611 (10) and 611(13) could be addressed by including a purpose qualification; that is, these sections could only be available as an exemption where acquisition of control by the underwriter was not a motive for the underwriting.

This amendment would clarify the purpose of the exemption and would support the approach taken by the Takeovers Panel in the Guidance Note on Rights Issues GN17 that was finalised on 10 January 2006.

Finsia believes that assessing the motives for an underwriting will generally be a matter of fact and that the Takeovers Panel is well placed to determine an incidence of unacceptable circumstances.



3 Conclusion

Finsia is committed to the highest standards in the financial services industry and providing thought leadership to improve the operation of the financial markets.

An efficient and equitable takeover legislation regime is a key determinant of the international competitiveness of a capital market. The proposals outlined in this package build on the CLERP reforms by facilitating a more competitive market for corporate control, providing greater commercial and international focus and improving the regulation of change-of-control transactions.

Importantly, by removing existing anomalies within the Corporations Act and focusing on enshrining the Eggleston Principles within all aspect of takeovers law in Australia, the important shareholder protections that currently exist are consolidated and enhanced.

