10 October 2008

Mr John Kluver
Executive Director
Corporations and Markets Advisory Council

Dear Mr Kluver

Re: Members' Schemes of Arrangement Discussion Paper

Finsia (the Financial Services Institute of Australasia) is a professional association representing more than 20,000 individuals working across the spectrum of the financial services industry in Australia and New Zealand. Finsia welcomes the opportunity to provide a submission on the Corporations and Markets Advisory Committee's *Members' schemes of arrangements Discussion Paper* released in June 2008.

By way of background, in April 2006, Finsia published a Takeovers Package Discussion Paper which considered, among other things, removing the inconsistencies between the regulation of schemes of arrangements and takeovers. In August 2006, Finsia published a Report on the Consultation to the Takeovers Package, which included a recommendation that the Government consult further on the removal of inconsistencies between the regulation of schemes of arrangement and takeovers. The relevant sections on removing the inconsistency between the regulation of schemes of arrangement and takeovers are extracted in this submission.

Finsia notes that paragraph 1.2.2 of CAMAC's Discussion Paper provides that '[it] does not purport to be an exhaustive review and respondents are invited to raise other aspects of members' schemes that may benefit from further consideration'.

Finsia commends CAMAC for the detailed discussion (chapter 2) on the different legal treatment and procedural mechanisms that underpin schemes of arrangement in comparison with takeovers. However, Finsia believes there is significant scope for 'regulatory arbitrage' in effecting change of control by scheme of arrangement in situations that would ordinarily be handled by takeovers. The policy rationale, backed by economic analysis, for maintaining two mechanisms for achieving similar results, should be appropriately canvassed.

Also in this context and in light of Finsia's previous work in the area, a detailed consideration of the merits in providing the Takeovers Panel with jurisdiction to hear disputes involving schemes of arrangement would be timely.

Yours sincerely

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Appendix 1: Extract from Finsia's Takeovers Package, released April 2006

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's 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 by:

- If the bidder starts the offer with less than 60% of the target, achieving a holding of the target of 90%; or

- **If the bidder starts the offer with more than 60% of the target, 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 takeovers 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 is 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" a concept provides sufficient flexibility to allow quantitative and qualitative assessment for all transaction types.

3. The thresholds for effecting a scheme of arrangement be 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 for approval of schemes of arrangement is removed (at odds with fundamental notion of corporate democracy, i.e. one vote per share).

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.

Appendix 2: Schemes of arrangement reform

(Adapted from Finsia presentation to Business Regulation Advisory Group (BRAG) meeting, 9 June 2007).

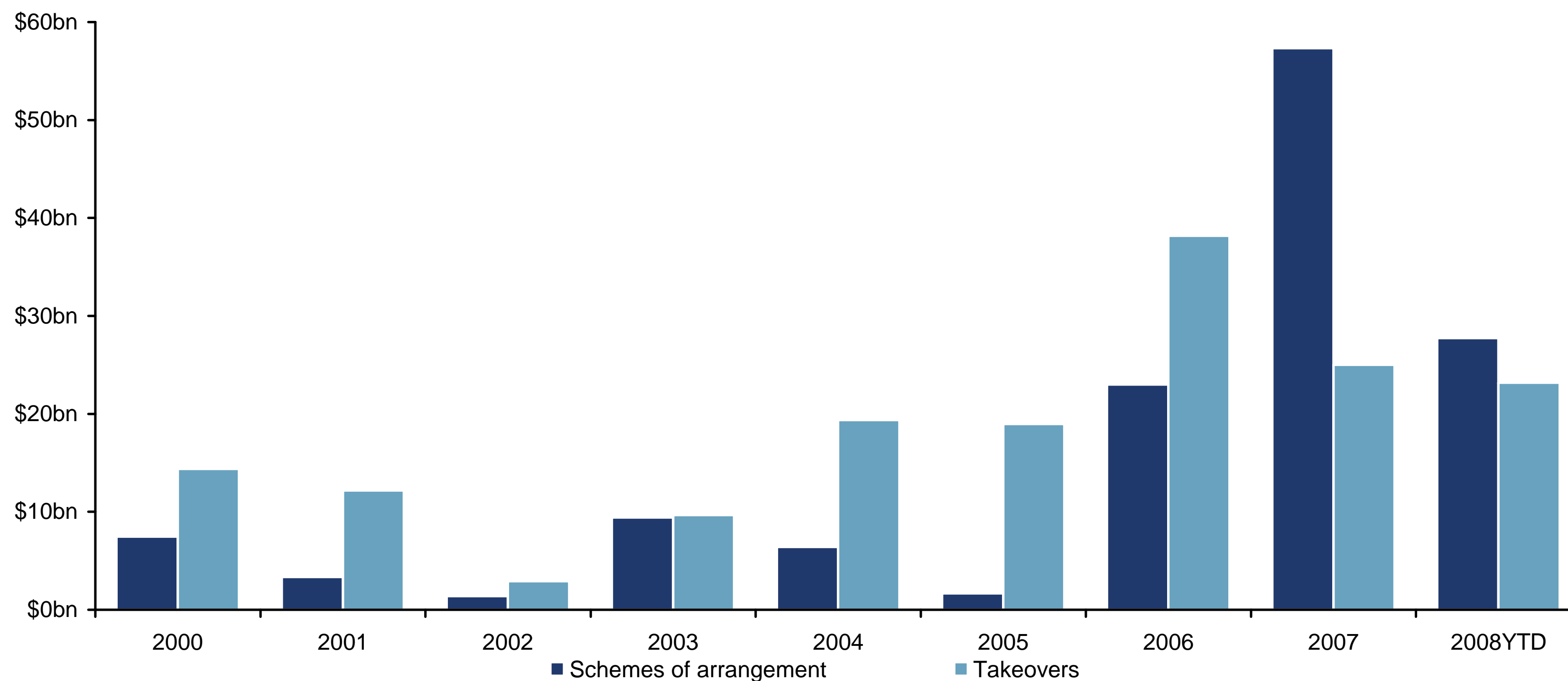
Issues

- Source of law:
  - Part 5.1, *Corporations Act 2001*
- Reasons for reform:
  - The framework permits a person who is seeking to gain control of a public company to carry out "regulatory arbitrage"
  - Finsia believes that the current usage of schemes of arrangement has resulted in shareholders being deprived of the protection which legislators intended they should have when takeover laws were formulated
  - As courts have supervisory jurisdiction in schemes of arrangement, different approaches are taken by different judges leading to a lack of certainty
- Recommended changes:
  - Review of law to remove anomalies and reduce "regulatory arbitrage"
  - Schemes of arrangement should not be available as an alternative methodology for achieving a takeover, or should be restricted (as the wording of section 411(17) suggests was the intention of the legislature) to transactions not achievable by way of takeover
  - Consideration should be given to broadening the role of the Takeovers Panel to replace the role of the Court in schemes of arrangement to ensure consistency with the Eggleston principles and to ensure that disputes are resolved by experts

Discrepancies between schemes and takeovers

Issue	Scheme	Takeover
Voting threshold	■ 75% of shares voted ■ 50% of shareholders voting	■ 90% of all shares
Independent expert test	■ In shareholders' best interests	■ Fair & reasonable
Acquisition of shares	■ Scheme can be done at any price	■ Offer must be at minimum value of the highest price paid for shares within 4 months
Role of regulators and court	■ Court: supervisory ■ ASIC: approval of documentation	■ Takeovers Panel is first forum for dispute resolution ■ ASIC: review of documentation
Pre-bid stakes	■ Likely to form separate class and be ineligible to vote	■ Counts toward meeting threshold
Eggleston principles	■ Included only by ASIC policy statement 60	■ Codified in legislation
"Competitive market principle"	■ Included only by ASIC policy statement 60	■ Codified in legislation

The rise and rise of schemes of arrangement (updated in June 2008)



Source: GSJBW research, public company filings

Methodology: All announced public market M&A transactions greater than US$250m since 1 January 2000 excluding BHP / Rio Tinto which has been removed given it is still being undertaken