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Attention: Mr John Kluver
Corporations and Markets Advisory Committee
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By email: john.kluver@camac.gov.au

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Dear Sir

Thank you for the opportunity to comment on the issues raised in CAMAC's discussion paper on "members' schemes of arrangement". RiskMetrics (formerly Institutional Shareholder Services) is the world's largest proxy voting advisory firm, providing governance research to more than 1700 institutional investors in Australia and around the world.

Scope of CAMAC's review

RiskMetrics notes that, while this discussion paper focuses on members' schemes, CAMAC has invited comment on other matters such as creditors' schemes and share acquisitions under s. 414. RiskMetrics also notes that the discussion paper examines the role of share capital reductions in change of control transactions. However, as CAMAC is aware, share capital reductions are now rarely used to effect changes of control or consolidate control through the removal of minority shareholders (see Damian and Rich, Schemes, *Takeovers and Himalayan Peaks* (Ross Parsons Centre of Commercial, Corporate and Taxation Law, 2004), pp. 9-10).

The same cannot be said for share buy-backs. Moreover, a company does not need to implement a selective buy-back (with its higher threshold for shareholder approval) in order to consolidate control of the company in the hands of a majority or substantial shareholder. That can be achieved through an on-market buy-back or an equal access buy-back. A majority or substantial shareholder can, by not participating in these buy-backs, increase its shareholding of the company. This being the case, RiskMetrics believes that CAMAC should consider examining the role of buy-backs in change of control transactions as part of these "other matters". As part of such a review, CAMAC should give consideration as to whether, in line with the Class Exemptions to the New Zealand Takeovers Code, a shareholder whose control of a company will be increased by a buy-back and its associates should be precluded from voting on the resolution required for on-market buy-backs and equal access buy-backs (which exceed the 10/12 limit).

Schemes of arrangement and protection of minority shareholders

Hostile change of control transactions are one of the most effective ways of enforcing good corporate governance. The threat that an unsolicited takeover bid will be made for a company and that control of the company will pass into the hands of a hostile outsider has proved very effective in ensuring that directors will monitor management and that both directors and managers will be accountable to their company's shareholders for underperformance or mismanagement. When designing or reviewing the mechanisms by which a change of control can be effected, it is essential – from the perspective of good corporate governance – to consider the appropriate balance between, on the one hand, facilitating hostile changes of control and thus increasing the efficiency of the market for corporate control and, on the other, protecting the interests of minority shareholders.

Change of control transactions effected by way of a members' scheme of arrangement are, however, inherently "friendly" in nature – in marked contrast to the mechanism for takeover bids in Chapter 6 which is neutral in this regard. The role of the target company in implementing a scheme makes it impracticable for schemes to be used to effect a change of control that does not have the support of the target company's directors and management (see Damian and Rich, pp. 56-57; Colla, 'Scheme Warfare: Navigating Contests for Control in Friendly Takeover Schemes' (2008) 26 C&SLJ 191, at 191). Accordingly, "improvements" to the Australian scheme mechanism will ultimately rebound to the benefit of the incumbent directors and management and may, in some cases, facilitate their entrenchment. RiskMetrics therefore takes the view that the options for reform detailed by CAMAC in its discussion paper need to be considered primarily from the perspective of protecting the interests of minority shareholders.

Disclosure

RiskMetrics supports the proposal to incorporate in the scheme of arrangement mechanism disclosure requirements (and defences) equivalent to those that apply to Chapter 6 takeover bids. This would have the benefit of formalising what has been the practice in relation to schemes of arrangement under which shareholders have been provided with information, in the notices of meeting for a scheme and accompanying explanatory notes, equivalent to that which they would have received under Chapter 6. This is also, as CAMAC notes, consistent with ASIC's current policy in reviewing draft scheme documents.

Shareholder meetings and the role of the court

RiskMetrics supports Damian and Rich's proposal that the court should be given the power to make a binding determination at the first court hearing on how shareholders are to be marshalled into classes. This will go a considerable way to reducing the uncertainty in the current scheme mechanism, where: (i) the process by which shareholders holding the same legal class of shares may be placed in different classes for the purposes of voting on a scheme is essentially a subjective process have regard to the rights and possibly also the extraneous interests of each shareholder (see Austin and Ramsay, *Ford's Principles of Corporations Law* (LexisNexis Australia, Looseleaf edition), para [24.110]; Renard and Santamaria, *Takeovers and Reconstructions in Australia* (LexisNexis Australia, Looseleaf Service), para [1519]); and (ii) it is only at the second court hearing, after the class meetings have already been held, that the company's division of its shareholders into different classes is confirmed or rejected. Damian and Rich's proposal would ensure that the company and hence its shareholders do not bear the expense of a scheme of a scheme being rejected at the second hearing simply for failure to divide the shareholders into the correct classes.

Damian and Rich's related proposal to give the court the power at the second meeting to "cure" procedural irregularities in relation to the shareholder approval process for schemes also has considerable merit, and RiskMetrics supports this proposal. This will make clear that the court's power to cure procedural irregularities in relation to meetings generally under s. 1322 applies to scheme meetings. It will also remove the prospect of "all or nothing" outcomes at the second hearing by allowing the court, for instance, to disregard votes that have been improperly cast by the bidder and its associates or validate class meetings, including where shareholders claim that they been placed in an incompatible class, as an alternative to rejecting the scheme.

Headcount test

RiskMetrics believes that the headcount test in s. 411(4)(a)(ii)(A) of the *Corporations Act* should be retained in its current form. The recent introduction of the words "unless the Court orders otherwise" addresses the criticisms that have been levied at the headcount test (eg that it creates a perverse incentive for share-splitting: see Damian and Rich, p. 133) while its retention provides

minority shareholders with an additional level of protection. This latter point is particularly important given the lower threshold for shareholder approval that needs to be obtained under s. 411(4)(a)(ii)(B) to eliminate minority shareholders compared to the threshold required to achieve a compulsory acquisition under Chapter 6A.

Shareholder voting

RiskMetrics would like to draw CAMAC's attention to the following aspects of shareholder voting in relation to schemes, each of which has the potential to cast doubt over the integrity of the shareholder approval mechanism for schemes, especially in the context of close results. CAMAC will be aware of the example of Rebel Sport in March 2007 where the proposed scheme of arrangement was approved by a very slim majority amidst concerns over discrepancies in the voting process: see *In the Matter of Rebel Sport Limited (No 2)* [2007] FCA458, at paras 7 and 9.

(i) **Audit trail for proxy voting**

Under the present system of proxy voting, the holders of shares or those entrusted with the exercise of voting rights attaching to shares do not receive from either the company or the company's share registry any confirmation as to the number of votes lodged and voted and the manner in which the votes were cast. This lack of an audit trail means that custodians, fund managers and superannuation funds as well as retail investors are unable to ascertain whether their proxies have been accepted by the company and exercised in the manner directed.

RiskMetrics wishes to draw CAMAC's attention to IFSA's submission on improving the proxy voting system in Australia made to the Parliamentary Joint Committee on Corporations and Financial Services (as part of the Committee's inquiry in 2007 into shareholder engagement and participation). RiskMetrics supports IFSA's recommendation that a meaningful audit trail from companies and their share registries to shareholders be implemented, so that shareholders can have confidence that their voting rights and any voting instructions given by them have been respected by the company.

(ii) **Cut-off date for proxy voting**

In addition, under the present system of proxy voting in Australia, there are two cut-off dates that are relevant to the ability to cast votes via proxies: proxy appointments must be received by a company at least 48 hours before a meeting (*Corporations Act*, s. 250B(1)); and the company's determination of voting entitlements for a meeting must be based on the persons who were shareholders not more than 48 hours before the meeting (*Corporations Regulations*, reg. 7.11.37(3)). The coincidence of these two cut-off dates creates the potential for discrepancies between the votes lodged via proxies and the votes held at the second of these cut-off dates (as, despite the flexibility in the first cut-off date, the company is effectively required to reconcile the votes lodged with voting entitlements no more than 48 hours before a meeting).

RiskMetrics wishes to draw CAMAC's attention in this regard to IFSA's submission (referred to in (i) above). IFSA's proposal to have an earlier date for determining voting entitlements – 5 business days before the meeting, rather than 48 hours – will provide sufficient time for this reconciliation of votes lodged with voting entitlements to implemented accurately. By reducing the time pressure for this reconciliation, this proposal will better ensure that shareholders' proxy appointments and voting instructions are respected and will also facilitate the creation of an audit trail.

(iii) **Oversight of votes**

It appears incongruous to RiskMetrics that those persons who may have a material interest in the outcome of a shareholder vote should have the responsibility for oversight of that vote (either directly or indirectly via board-appointed agents such as auditors or share registries). This material interest will clearly be present where the scheme involves a management buy-out or other acquisition which, if implemented, would result in the incumbent directors and management of the target company receiving shares in the bidder or the merged entity.

The UK *Companies Act 2006* contains provisions that address this issue and which, if adopted in Australia, would allow shareholders (the UK threshold for this is equivalent to the 5% voting power/100 headcount thresholds that apply under the *Corporations Act* to the rights of shareholders to requisition meetings and put resolutions at meetings) with concerns about the result of a poll at a scheme or other meeting to call immediately for the poll to be reviewed by an independent assessor: ss. 342-344. The UK provisions also entitle shareholders to have an independent assessor appointed ahead of a poll being taken to oversee the poll.

At present, in Australia, if the directors of the company decline to have a result reviewed, the only recourse of the shareholders is to seek to have ASIC review the result after it has been declared. ASIC investigations can be problematic due to the short space of time between the scheme meeting and the court hearing in which the final orders to approve the scheme of arrangement are made.

(iv) **Securities loans**

The recent regulatory scrutiny of short selling worldwide has also focused attention on the principal means for facilitating short selling, namely securities loans. However, apart from allowing market participants to source shares for the purposes of short selling, securities loans enable the effective “borrowing” of voting rights free of the economic interest in the company that ordinarily accompanies voting rights.

Under a securities loan, shares are “lent” temporarily to a borrower against the return of equivalent shares. This so-called loan involves the transfer of title to the shares to the borrower but the economic incidents of the shares remain with the lender (as the borrower is required to pay to the lender amounts representing dividends and other distributions received on the shares during the term of the loan and, on termination of the loan, equivalent shares will be returned to the lender at a pre-agreed price).

As voting rights to shares pass with title, the borrower has use of the votes attaching to the shares for the term of the loan. The lender retains no right to vote the shares during the term of the loan. The standard form contract used in the Australian market – the Australian Master Securities Lending Agreement – provides for the borrower to use its best endeavours to vote the borrowed shares in accordance with the lender’s wishes (cl. 4.3) but, in practice, the only way in which the lender can be certain that the shares are voted as desired is by terminating the loan and “recalling” equivalent shares from the borrower.

The “decoupling” of voting rights from an economic interest in the company carries the potential for shares to be borrowed for the sole purpose of casting the votes attaching to the shares: see Hu and Black, ‘Equity and Debt Decoupling and Empty Voting II: Importance and Extensions’ (2008) 156 *University of Pennsylvania Law Review* 625, at 641. This can distort the results of shareholder voting, particularly in relation to controversial matters or other matters on which shareholder views are finely balanced. The voting result in that situation may not necessarily reflect the interests of the majority of shareholders that hold

both title to and the economic incidents of shares. This is of even greater concern in the context of a scheme of arrangement as the borrower of shares could easily be placed in a class where the borrower has no commonality of interest with the other members of the class (and the vote that class could be decisive in determining whether or not the scheme proceeds).

Securities lending, when used to "borrow" votes, can also have an effect beyond the shares actually borrowed. Even if not voted, those shares are no longer available to the lender (unless recalled) nor do they form part of the free float of shares of the company. This has the potential to influence the outcome of a close contest by withdrawing votes from, for example, the opposition to a proposed scheme. Moreover, where the borrowed shares are actually voted in favour of a scheme, the impact on the opposition is effectively doubled (the votes are not available to them or their potential supporters and have, instead, been voted against them).

RiskMetrics believes that the concerns raised by the decoupling of voting rights and economic incidents can be addressed by making securities lending activity more transparent. While the substantial shareholder disclosure provisions in Chapter 6C of the *Corporations Act* are capable of being triggered by securities loans in respect of substantial shareholdings, those provisions are not specifically directed at securities loans and nor do they specifically address the concerns with securities loans. RiskMetrics has closely followed the recent changes to the regulation of short selling in the Australian market (and also in other markets) and strongly supports the proposal – set out in the Commentary released by the Australian Treasury on the exposure draft of the *Corporations Amendment (Short Selling) Bill 2008* – for the disclosure of all securities lending transactions.

Section 411(17)

RiskMetrics does not support the proposal to repeal s. 411(17). The repeal of this provision has, as CAMAC notes, the potential to reduce ASIC's role in reviewing schemes and that, particularly in the case of relatively complex schemes, may be to the detriment of minority investors. The utility of s. 411(17) lies not so much in the over-arching requirement that a scheme must not be used for the purpose of avoiding Chapter 6 (which, in practice, has not been used by the courts as a basis for rejecting schemes) but in the fact that that provision enables ASIC to ensure that schemes are implemented in a manner consistent with the Eggleston principles (see ASIC, 'Schemes of Arrangement – s411(17)', *Regulatory Guide 60*, 1999, at 60.8; Lindgren, 'Private Equity and Section 411 of the Corporations Act 2001 (Cth)' (2008) 26 C&SLJ 287, at 291).

RiskMetrics, instead, strongly supports the solution suggested by Mr George Durbridge (CAMAC, p. 71). This has the dual benefits of ensuring that ASIC's current role in the review of schemes is not lessened (the repeal of s. 411(17) carries the risk of undermining the protection afforded to minority shareholders by ASIC's involvement) and addressing the uncertainty created by the present wording of s. 411(17) (see Renard and Santamaria, para [1507]). Mr Durbridge's proposal, if implemented, would also ensure clarity as to the uniformity of regulatory treatment of change of control transactions effected via schemes and Chapter 6 bids and, moreover, would eliminate any problem of regulatory arbitrage where a scheme is resorted to mainly for the purpose of by-passing the more rigorous requirements of Chapter 6.

RiskMetrics also notes that, while ASIC is explicitly given a reasonable opportunity under s. 411(2) to review the draft scheme documentation, it has no such luxury in relation to its production of a statement for the purpose of s. 411(17)(b). This time pressure means, in particular, that ASIC, as a practical matter, is forced to rely on the information provided to it by the company as regards the outcome of the shareholder vote and the manner in which votes by proxy have been dealt with and cast. In the absence of any requirement for an audit trail or independent oversight of the voting process, there is a risk that ASIC may be compelled to issue a statement under s. 411(17)(b) that is

based on flawed information provided by the company. The lack of sufficient time for ASIC to undertake a review of shareholder vote (when coupled with the lack of an audit trail and independent oversight) has the very real potential to undermine the protection afforded to minority shareholders by ASIC's review of schemes.

Managed investment schemes

RiskMetrics supports the extension of the scheme of arrangement mechanism to both listed and unlisted management investment schemes. ASIC involvement and judicial review will, as CAMAC notes, provide minority shareholders with a formal measure of protection that is currently lacking in relation to change of control mechanisms such as "trust schemes".

Please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail. Thank you once again for the opportunity to comment on the issues raised in your discussion paper.

Yours sincerely

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