Report

DYNAMO 72

4.2011

Takeover – My cup of Tea

As the reality of dispersed control progresses in Brazil, the chances for an effective market for corporate control increase in our country. As a suggested screenplay to investigate the issue of unsolicited takeover offers, we chose to analyze the comparative experiences of developed markets. In the previous Report, we devoted most of the time trying to explain a counterintuitive evidence: in U.S., where capital markets are sophisticated, liquid, transparent and offers good investor protection, on the subject of takeovers, regulatory decisions clearly take a pro-management bias.

We saw that various interconnected ingredients explain this intriguing puzzle. An unique, hybrid, institutional reality, combining elements of common and civil law, in addition to political factors that allowed certain players – company executives and state officials – to dominate the regulatory agenda of takeover transactions in that country.

The idea now is to cross the Atlantic and investigate another system, the British one. Unlike the United States, the UK model is friendlier to shareholders. Hence, there is no need to replicate the previous task of seeking the reasons for the anomalies of the pro-management American regulation. In this case, we prefer to devote time to describe the structure of the Takeover Panel. At the end, having in hand the comparative experiences of these two countries, we move the discussion to Brazil, critically analyzing our possibilities.

The Panel

On the topic of regulating takeovers, the British reality is very different from the American. In the City, the rules of the neutrality of the board and the compulsory offer prevail. On the first, executives are unable to establish any defenses without prior authorization from shareholders. Poison pills are strictly prohibited as are any other mechanisms that constrain shareholders' decision on the fate of the offer. On the second, buyers are required to make a mandatory bid to all other shareholders if they exceed an ownership threshold of 30%. One protects shareholders against executives with a misaligned agenda, while the other ensures shareholders get a strictly equitable treatment in takeovers.

Similarly to the U.S., the history of hostile takeovers in the UK dates back to the 1950s. The first regulatory initiative came at the end of that decade, when the Bank of England (BE) set up a committee composed of a group of market participants (commercial banks, institutional investors, the London Stock Exchange) to devise a code of conduct to regulate takeover offers. Interestingly, the initiative appears to have been stimulated, at least in part, by the fear that if nothing was done, the matter could be embraced by legislators as the subject was hovering around the Labour Party´s agenda (see Armour, 2006). That is, a model of self-regulation, although not genuinely spontaneous, or typically self-organized. Instead, an arrangement that emerged as a result of external factors.

In the fall of 1959, the BE committee released the general guidelines of the document *(Notes on Amalgamation of British Business)* that where "concerned primarily to safeguard the interests of shareholders", suggesting, among other things, that the decision to sell in an offer should be made at the sole discretion of these stakeholders. It was thus established the principle of shareholder primacy and the neutrality of the board.

The Takeover Panel (Panel) was established in London in 1968, the same year of the Williams Act in US, and soon established itself as the main regulatory body of transactions involving change of control and corporate reorganization. The Panel reinforced the pro-shareholder tone of the previous document, in a more comprehensive and specific fashion, setting, for example, a broad ban on initiatives that could frustrate an offer. The mandatory bid rule emerged soon after in 1972, imposing a limit of 40% to trigger the compulsory acquisition of other shareholders. This limit would be reduced to 30% in 1974 and has not changed since then.

The Takeover Panel is a private entity, non-statutory, independent of the government, funded with its own resources, which regulates the conduct of takeovers, mergers and other transactions involving change of control. The Panel does not address the merits of commercial and financial issues, or consider public interest issues such as market concentration and consumer rights.

At the time of its creation, the mergers and acquisitions environment in the UK was "in a kind of mess" and the rules protecting minority shareholders in these deals, as well as executives' responsibilities, were poor. Physically, the Panel is located in the building of the London Stock Exchange (LSE). Its members are representatives of the LSE, BE, the big commercial banks, institutional investors and members of the business world. In theory, the main players who have interests in the market for corporate control are represented on the Panel.

The structure of the Panel is formed primarily by the Hearings Committee, the Code Committee, and the Panel Executive. The Panel Executive is responsible for day to day regulation, supervision and investigation of the participants, and the interpretation and application of the rules of the Takeover Code. Its members are available for consultations and to provide guidance before, during and after transactions. The Hearing Committee, aside from reviewing the decisions of the Panel Executive, also monitors the disciplinary procedures issued by the Executive when it interprets that any rule of the Code was violated. Finally, the Code Committee is responsible for the legislative function, basically proposing and implementing any updates to the Code.

The purpose of the Code is to ensure that shareholders are treated fairly (and equally, if in the same share class) and not be denied the possibility of voting on the merits of the offer. The Code provides an orderly framework within which takeovers can be conducted. It is based on general principles as rules are not exhaustive, it admits flexibility (waivers) and was written in a non-technical language. Over its forty years, the Code has undergone little change, while it has served to effectively regulate an environment that is complex, innovative, and in profound transformation.

Breaking the Code subjects the offender to public and private censorship by the Panel. This reputational constraint has been enough for participants to respect the guidelines of the Panel. Only on two occasions in recent history (1992 and 2010), the Panel used the prerogative of the "cold shoulder", a kind of public statement of ban, prohibiting any other participants of working on behalf of the player who refused to adhere to the rules of the Panel. Throughout this period, there was no need for additional sanctions. In 2006, when the Panel revised the Code, motivated by the implementation of the European Takeover Directive, the British government suggested other sanctions, including fines, which were rejected by the Panel. Nevertheless, the Panel has gained new powers, for example, to get from the courts the enforcement to comply with of its rules, to impose a fine as compensation to investors when its rules are violated and to invoke statutory powers when appropriate.

Violations of the rules have been very rare. Perhaps the main explanation for this is the habit of the participants to consult the members of the Executive, which are available full time. This continuous interaction avoids misconducts that could lead to retroactive effects and reprimands that slow the process. Thus, decisions and responses from the Executive are usually swift and transactions move at a pace compatible with businesses requirements.

Recommendations and decisions of the Executive are subject to motions of appeal. Participants can appeal to the Hearing Committee and to a higher court, the Takeover Appeal Board, an independent panel, whose chairman is appointed by the Master of the Rolls[1]. Appeals have also been very infrequent. In the last decade, the Panel recorded ten appeals to the Hearing Committee and only one to the Takeover Appeal Board. The Appeal Board's decisions are subject to judicial review. Throughout the Panel's history, there were four judicial reviews, the last in 1992. In all of them, the courts declined to interfere with the decisions of the Panel (see Pullinger 2009).

UK x US

An important element that helps explain the differences between British and American regimes was the role played by institutional investors. As we saw in our prior Report, the history of U.S. capital markets in the last century shows a frequent willingness of politicians to intervene in order to keep the dispersed capital structure, preventing large institutions of gaining size and relevance in the corporate governance agenda. Only in the 1990s, when the Delaware doctrine was already consolidated, institutional investors emerged as important players in the battle for corporate governance. This populist impetus behind the legislation that imposed severe restrictions on the activities of these investors has produced unintended consequences of securing considerable autonomy to executives at the expense of control by the shareholders.

In the UK, the story played out quite differently. Institutional investors were present and active from the beginning. Once again, legislative actions produced unintended consequences. For example: high income taxes on individual investments and tax reliefs on collective investment arrangements, including zero taxation on dividends received by pension funds and lower tax rates for insurance companies.

With a propensity of active participation, these institutional investors began to influence rule-making and the formation of institutions that shaped the British capital markets. The Takeover Code is a typical example. As the interests of institutional investors converge with the agenda of maximizing shareholder value, it is not surprising that the direction of regulation in the City has taken on pro-shareholder features

1 *Master of the Rolls is the second most senior judge in the UK after the Lord Chief Justice. The first account of this role dates back to 1286.*

and that this trend coincided with the increasing participation of these investors in the shareholder base of listed companies.

In a comparative analysis, the British model has advantages over the American. First, its agility. The Panel addresses issues in real time, responding promptly to requests. On average 90 days go by from receiving the bid until the final close of the transaction in the UK. Thirty days from the receipt to the publication notice and more sixty days from the publication until the final result. The Delaware courts also tend to be very quick in its decisions once the parties have completed presenting their arguments. Delaware is an extremely specialized forum, renowned for its technical competence. It turns out that the ritual of the formal process must respect the legal deadlines, which in turn greatly lengthen the total time of the transaction. In addition, litigation is a defensive tactic often used by the boards of target companies. A typical M&A transaction in the United States usually takes about five months to complete. In hostile takeovers, the time span is even greater.

Another advantage of the Panel is its flexibility. One function of the Executive arm of the Panel is to maintain a continuous interaction with stakeholders, adjusting the regulatory requirements of the particular agents and business needs. These adjustments serve as inputs to the Code Committee to update the provisions of the document, immediately reflecting the changes to the market environment. The regulatory regime is therefore more dynamic and proactive. On the other hand, in the United States, the model is essentially characterized by its reactivity: the interactions lead to business litigation and, thereafter directing the Court to set acceptable behavior for the agents involved.

The British model is also more economical. Litigation is an expensive way to resolve disputes, and in the United States, about one third of hostile takeovers end up in court. In the UK, much of the regulatory issues are resolved through phone contacts with the staff of the Panel, whose operations are funded by a modest fee paid by the participants.

There are also significant differences in the profile of the players involved. Panel members generally come from the member institutions. They are experts in finance or from the corporate world. They have technical knowledge and are familiar with the business world. In the American model, although the courts of Delaware are also highly specialized, the subject of takeovers is decided by lawyers and judges. While the Panel is concerned more with substance than with form, the agenda in the United States is dominated by a more legalistic and procedural mindset.

An example illustrates the differences in processes between the two systems. The issue on the use of derivatives in attempts to acquire control emerged around the same time in both countries. The so-called "contracts for differences" in the UK or "equity swaps" in the United States began to be used by some investors as a means to accumulate economic interest in the companies, without appearing as effective shareholders (beneficial owners), thereby circumventing the obligation to disclosure their holdings.

In January 2005, the Panel initiated a public consultation to receive proposals from agents on "Dealings in Derivatives and Options." Only fifteen months later, in April 2006, after three external consultations and numerous suggestions, the Code Committee of the Panel issued a final document, updating the disclosure rules to include positions in derivatives, closing the loophole of "hidden" dealings. The statutory provision came later. The public hearing organized by the FSA was installed in November 2007 and in July 2009 the British authority issued a regulation on the subject.

In the United States, the issue gained notoriety in late 2004 due to the offer by *Mylan Laboratories* of *King Pharmaceuticals*[2]. But the matter only reached the courts in 2008 in the *TCI x CSX* case. Throughout 2006 and 2007, the British hedge fund TCI and 3G Partners (funds) investment fund acquired shares of CSX, a rail company, directly and through stock swaps with five different investment banks. When the funds announced their intention to launch a proxy solicitation seeking to elect members of the board, CSX took the case to the court of the District of New York in March 2008. Shortly thereafter, the District Court issued a decision concluding that the funds violated the SEC's rules of disclosure, which require a notification by shareholders with more than a 5% stake, but allowed the funds to exercise the voting power of the shares they owned directly. It turns out that shortly thereafter the SEC issued a favorable *amicus letter* to the funds, stating that equity swaps do not trigger disclosure obligations. As the Court had asked the regulator to formally rule on the matter, the case was still pending. Only in March 2011, the SEC announced that it would be collecting suggestions to amend the disclosure requirements of swaps (Release No. 34-64087). In the meantime, the funds' appeal was ongoing in Federal Court. Three years went by, and in July 2011, the Court of Appeals finally ruled. The judge found several "flaws" in the reasoning of the District Court, acknowledged that the subject had generated "disagreement" among panel members and thus, was unable to issue a final decision, requiring "further consideration". That

2 *With the announcement of the transaction, King's shares appreciated and Mylan's shares fell. The hedge fund Perry Corp., which held an investment in King (target company), acquired a 9.99% stake in Mylan (offeror), hedging its position in the market. As a result, the fund achieved its goal of influencing the operation. In fact, Perry Corp. became the company's largest shareholder, holding nearly 10% of voting rights, and zero of its economic rights. As the largest voting shareholder, the fund had a conflicting interest with the company (offeror), as it had a net exposure in the target company. That is, the higher the price to be paid by Mylan in the acquisition of King, the better for the hedge fund.*

is, after a number of years the issue of derivatives (equity swaps) still has not received a final regulatory decision in the United States, neither with the SEC or the courts.

Therefore, given the evidence examined, on the topic of offers for control, the American model grants more defensive power to executives, while the British model grants shareholders the ultimate say. In the United States, decision-making rests with Congress and with States / Districts Courts. In the UK, through an arrangement of self-regulation, the Panel decides. Although it cannot be said *ex ante* that one model is superior to the other, the British regime appears to be faster, cheaper and more proactive. Hence, more appropriate to the requirements of a dynamic business environment.

Still, it is not immune to criticism. Following the acquisition of Cadbury, one of the UK's most admired brands, by the US-based Kraft Foods in January 2010, the Panel faced harsh disapproval by the British public opinion. According to critics, the rules of the Panel did not provide appropriate tools for a reasonable defense. In addition, the Panel was unable to react when Kraft later shut down the Somerdale plant, breaking a "campaign" promise made during the bid to not destroy jobs in the country.

The answer, once again, came quickly. In July 2010, following a public consultation and after analyzing the participants' suggestions, the Code Committee recognized that "hostile offerors have, in recent times, been able to obtain a tactical advantage over the offeree company to the detriment of the offeree company and its shareholders". Only one year after the verdict in July 2011, the Committee announced the new text of the Code, with updated amendments. Among them, for example, the reduction of the time period that offers remain outstanding from eight weeks to 28 days, requiring a greater commitment and sense of urgency from the bidders[3].

In Brazil

With this more pro-shareholder approach, it would be reasonable to expect that the British system is a natural reference for countries moving towards a more dispersed ownership structure, as is the case with Brazil.

In fact, some local market participants began an effort to lay the foundations of a Committee of Mergers and Acquisitions (CFA or Committee), similar to the Panel. That is, a private body, of voluntary self-regulation, composed by market participants, establishing principles and rules (the Code) applicable to the operations to be analyzed within the jurisdiction of the Committee[4]. Like the British model, the basic premise of the Committee establishes that the final decision on the fate of transactions rests solely with shareholders, not allowing the company's management to take any action that will thwart the sovereignty of the decision by the shareholders.

CFA's proposal requires some fine-tuning to our reality, as we already have a government agency (the CVM), responsible for the regulation of the operations of reorganizations and change of control transactions. In this case, the role of the CFA should be complementary to the job of the regulator, "establishing principles, rules of conduct, and standards *additional* to those already resulting from the law and from the actions of the CVM"[5].

The British experience can also provide some insight to this hybrid model. Since 2006, after the implementation of the EU Directive, the UK lived with an institutional dualism. One statutory, the Directive, and the other self-regulatory, the Panel. In practice, the Directive simply endorsed the rules of the Code. At first it was feared that the inclusion of statutory rules could encourage the emergence of litigations, which did not occur. With the Directive, the Panel has gained legal standing, without losing control of its regulatory powers, nor its distinctive attributes: speed, flexibility and certainty in decisions.

It is true that the order of play is reversed. In the UK, it was long the experience of self-regulation when the statutory rule arrived. Here in Brazil, the institutional standard is the rule of law, and now a private body self-regulation model is being considered. It was questioned in the UK whether the change would stimulate an undesirable culture of litigation, while here in Brazil the question is whether the decisions of the CAF would be sufficient enforceable to avoid disputes in court.

In theory, for the regime of self-regulation to work well, participants should make themselves represented, and gathered under a single reputational identity. Geographical proximity also helps. It has been said that one reason for the success of the self-regulating model in the UK is due to the fact that all major market players are physically very close to each other, around London´s ancient business district (see Armour 2006). In this sense, the reality of a capital markets more deregulated and open since the 1990s is challenging this so-called parochial harmony. New institutional arrangements and/or new players with different strategies and sometimes

3 *In the British regime, once the offer is placed, the board of directors of the target company is no longer allowed to take any defensive measure. In this case, the offeror has a free path to deal directly with the shareholders of the target company. By shortening the offer period, the Panel felt it would reduce the maneuvering time of the offeror, thereby bringing greater balance to the dispute.*

4 *We already have a successful experience of self-regulation in the financial sector, whose foundations were laid out in 1991 through the Code of Ethics of the ANDIMA (Brazilian Financial and Capital Markets Association), which has since then directed the conduct of its member institutions.*

5 *Eizirik, N., at alli (2010), Proposal for the creation of the CAF, submitted to the BM&FBovespa. Emphasis in the original. Free translation.*

rivals could threaten the balance of interests of this "club" of incumbents. As an example, the growing presence of hedge funds with short positions, whose interests at times may be contrary to the good performance of the shares and the market in general. Another typical example of changes in an environment of self-regulation is the phenomenon of demutualization of Stock Exchanges, in that it opens a discussion about the potential conflict between business interests and the duties of self-regulation of exchanges. Hence it was no surprise that the CVM undertook upon itself to address this issue through instruction n. 461, where multiple governance procedures are instituted (Board and Department of self-regulation, Board of Directors comprised mostly of independent members) to ensure that the new reality of the ownership structure of the BM&FBovespa does not harm "the proper functioning of markets."

External experience shows that the regime of self-regulation has proved effective in dealing with isolated behaviors that diverge from established standards of conduct. The system is appropriate to identify and repel strange practices, developing effective autoimmune mechanisms. However, when the market collectively acquires bad habits, self-regulation model has difficulty correcting the deviations. For example, in the early 1990's, the British market adopted practices of selling pension plans to individuals in a way that violated the established rules. The FSA had to intervene by imposing compensations which reached £11 billion to almost two million investors. The self-regulation system was unable to address the issue (see Davies, 2004).

As a natural consequence of the tendency towards dispersed ownership, we should expect a greater recurrence of offers for acquisition of control in Brazil. With such a premise, the issue of regulation of these offers has now come to the forefront. Throughout these two Dynamo Reports, we investigated the two most active markets for takeovers. The American, very particular, is based on a hybrid model, the civil law / common law, where the regulatory mandate of the federal agency co-exists with the jurisprudence of state courts. The result is a legalism which lengthens the time of transactions and a tendency of pro-executive decisions, which goes against the recommendations of the handbooks of corporate governance practices.

Yet the British system is interesting due to the known virtues of self-regulation: agility, flexibility and accuracy. It turns out that, for its proper functioning, it needs some pre-conditions which are increasingly difficult to align in the world today: physical proximity, broad representation and convergence of interests between major market participants. In addition, self-regulation proves insufficient to deal with collective misconduct or with externalities that go beyond the focus of specific interests of participants. For these limitations, even in UK the regime of self-regulation is being accompanied by statutory provisions, by the rule of law.

The success of self-regulation system depends on an effective enforcement capability via reputational embarrassment. Otherwise, the system loses credibility and typical free rider and adverse selection problems arise. In Brazil, where we already have a tradition of an active federal regulator, the initiative of a private institute with complementary functions seems conceptually interesting. In practice, we need to ensure that these pre-conditions mentioned above are present from the beginning.

Before wrapping up, a quick reminder. Even if the scope of the CAF's work extends beyond unsolicited offers, it would be illogical to refrain our country from an effective market for corporate control at the time that an increasing number of companies move towards a dispersed ownership structure. Hence, it would be appropriate to revisit the issue of "mechanisms of protection against dispersion" our tropicalized poison pills. The dispersion of capital without effective dispersion of control is ineffective. In fact, it is a setback, a 360° turn. Dispersed ownership with defined control brings back the undesirable and perverse pyramidal structures of the "old" ON / PN regime, precisely a deformation the Novo Mercado sought to abolish.

Rio de Janeiro, January 17th, 2011.

DYNAMO COUGAR x IBX x IBOVESPA
Performance up to December/2011 (in R$)

Period	Dynamo Cougar	IBX average	Ibovespa average
60 months	120,9%	35,2%	27,4%
36 months	139,4%	56,9%	51,0%
24 months	31,9%	-8,9%	-16,9%
12 months	7,6%	-11,6%	-18,3%
Year to date	7,6%	-11,6%	-18,3%

NAV/Share on December 30th = R$ 324,708924733

DYNAMO COUGAR x FGV-100 x IBOVESPA
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Year	DYNAMO COUGAR* Since 01/09/93	FGV-100** Year	FGV-100** Since 01/09/93	IBOVESPA*** Year	IBOVESPA*** Since 01/09/93
1993	38,8%	38,8%	9,1%	9,1%	11,1%	11,1%
1994	245,6%	379,5%	165,3%	189,3%	58,6%	76,2%
1995	-3,6%	362,2%	-35,1%	87,9%	-13,5%	52,5%
1996	53,6%	609,8%	6,6%	100,3%	53,2%	133,6%
1997	-6,2%	565,5%	-4,1%	92,0%	34,4%	213,8%
1998	-19,1%	438,1%	-31,5%	31,5%	-38,4%	93,3%
1999	104,6%	1.001,2%	116,5%	184,7%	69,5%	227,6%
2000	3,0%	1.034,5%	-2,6%	177,2%	-18,1%	168,3%
2001	-6,4%	962,4%	-8,8%	152,7%	-24,0%	104,0%
2002	-7,9%	878,9%	-24,2%	91,7%	-46,0%	10,1%
2003	93,9%	1.798,5%	145,2%	369,9%	141,0%	165,4%
2004	64,4%	3.020,2%	45,0%	581,2%	28,2%	240,2%
2005	41,2%	4.305,5%	30,8%	790,7%	44,1%	390,2%
2006	49,8%	6.498,3%	43,2%	1.175,8%	46,4%	617,7%
2007	59,7%	10.436,6%	68,4%	2.048,7%	73,4%	1.144,6%
2008	-47,1%	5.470,1%	-50,1%	973,3%	-55,5%	453,7%
2009	143,7%	13.472,6%	151,9%	2.603,3%	144,0%	1.250,7%
2010	28,1%	17.282,0%	15,2%	3.013,2%	6,2%	1.334,5%
2011	-4,4%	16.514,5%	-20,6%	2.373,0%	-27,4%	941,7%

2011	DYNAMO COUGAR* Month	DYNAMO COUGAR* Year to date	FGV-100** Month	FGV-100** Year to date	IBOVESPA*** Month	IBOVESPA*** Year to date
JAN	-4,8%	-4,8%	-2,2%	-2,2%	-4,0%	-4,0%
FEB	2,9%	-2,0%	0,3%	-1,9%	1,3%	-2,8%
MAR	7,7%	5,6%	4,1%	2,2%	4,0%	1,1%
APR	3,4%	9,1%	2,6%	4,8%	-0,2%	0,9%
MAY	0,4%	9,6%	-0,8%	3,9%	-3,1%	-2,3%
JUN	-0,5%	9,0%	-2,3%	1,5%	-1,9%	-4,1%
JUL	-3,7%	4,9%	-5,0%	-3,6%	-5,6%	-9,5%
AUG	-3,1%	1,6%	-4,4%	-7,8%	-6,1%	-15,0%
SEP	-15,0%	-13,6%	-19,4%	-25,8%	-19,9%	-31,9%
OCT	17,4%	1,5%	20,6%	-10,5%	22,5%	-16,6%
NOV	-5,8%	-4,4%	-9,8%	-19,2%	-8,9%	-24,1%
DEC	-0,1%	-4,4%	-1,7%	-20,6%	-4,4%	-27,4%

Average Net Asset Value for Dynamo Cougar (Last 12 months): R$ 1.527.771.709,00

(*) The Dynamo Cougar Fund figures are audited by Price Waterhouse and Coopers and returns net of all costs and fees, except for Adjustment of Performance Fee, if due. (**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa average.

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DYNAMO

DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA.
Av. Ataulfo de Paiva, 1235 / 6° andar. Leblon. 22440-034. Rio. RJ. Brazil. Phone: (55 21) 2512-9394. Fax: (55 21) 2512-5720

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