

# The Legislative Framework of Share Buy-backs -A Comparison of the 'Old' and 'Existing' Requirements

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Share buy-backs were first introduced in November 1989, but have only recently gained recognition from the business community and accordingly become more prevalent over the 1995 to 1997 period.<sup>1</sup> A number of reasons have been proposed to explain the initial reluctance, as well as the corresponding recent interest and activity. First, the amendments to the buy-back legislation, as introduced by the First Corporate Law Simplification Bill (FCLSB), have facilitated the conducting of buy-backs. Second, the economic climate over this period is viewed as more conducive for buy-back activity.<sup>2</sup> Third, buy-backs have become more 'fashionable' among Australian companies.<sup>3</sup> Fourth, managers and shareholders alike have become more familiar with the concept of buy-backs.<sup>4</sup> Fifth, the Australian perception of buy-backs has altered and this restructuring activity is now viewed fa-

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<sup>1</sup> During the first six years (1990-1995), some 67 buy-backs by 44 listed companies are identified (see J Mitchell and P Robinson, 'Motivations of Listed Companies Effecting Share Buy-backs' (1999) 35(1) *Abacus* 91. Recently, the level of buy-back activity has increased significantly -- for the calendar year 1995 - 15; for 1996 - 39 and for the first half of 1997 - 33 buy-backs were announced.

<sup>2</sup> M Lyons, 'Conditions are Right for a Share Buy-back Boom' *Australian Accountant* (May 1995). A *Study of On Market Buy-backs* by Price Waterhouse in April 1992 concluded that the prevailing economic conditions in Australia at that time contributed predominantly to the disinterest of companies in buy-backs.

<sup>3</sup> A Deans, 'Buy-backs Deserve a Place', *Australian Financial Review* (1 May 1995) p 68.

<sup>4</sup> One of the conclusions from the survey by G Dharmaowan, J Mitchell, A Clarke and P Robinson 'Managements' Views on Buy-backs: An Australian Survey' *update of Working Paper 97-69* in The Research Centre in Accounting and Finance, *Accounting and Finance* (Forthcoming) is that managers were concerned about the negative perception of the sharemarket in relation to share buy-backs, hence this partly explains the limited number of buy-backs.

avourably.<sup>5</sup> Sixth, more companies simply now acknowledge the need to utilise their buy-back power.

Australian studies on share buy-backs have addressed the company-specific, or idiosyncratic, motivations. Mitchell and Robinson examined the motivations provided in Australian Stock Exchange (ASX) announcement for share buy-backs conducted prior to the December 1995 FCLSB amendments.<sup>6</sup> The two prime motivations for on-market buy-backs were found to be: (i) signalling of future expectations (underpricing) and (ii) an attempt to increase financial performance and/or position. For selective buy-backs, the main purpose was to remove specific shareholders from the share register and equal access buy-backs were seen primarily as an alternative to dividends. Capital market event studies find positive abnormal returns on buy-back announcements,<sup>7</sup> while financial characteristics have been used to distinguish buy-back, relative to non-buy-back, companies.<sup>8</sup> A recent survey of managements' views on share buy-backs by Dharmawan, Mitchell, Clarke and Robinson has been conducted with direct reference to the issues of share market response, legal complexity and reservations concerning buy-backs.<sup>9</sup> However, the above studies do not address reasons for the fluid and/or increased recent interest in buy-backs. The exception is the survey paper by Dharmawan, Mitchell, Clarke and Robinson which made some specific findings which are considered in detail below.

A major factor in explaining the renewed interest in buy-backs is the first reason proposed above, namely, the extent of the influence of legal considerations and/or the relative complexity of Australian buy-back legislation. The complexity of the original buy-back legislation has been quoted by a number of sources as one of the reasons for the limited number of buy-backs up until December 1995. As an illustration, the Corporations Law Simplification Task Force argued that few Australian companies had undertaken buy-backs because the previous ('old') provisions were 'complicated, include expensive and un-

<sup>5</sup> T Harris and I Ramsay, 'An Empirical Investigation of Australian Share Buy-backs' (1995) 4 *Australian Journal of Corporate Law* 393.

<sup>6</sup> J Mitchell and P Robinson, note 1 above.

<sup>7</sup> T Harris and I Ramsay, note 5 above. C Christianto, A Clarke, J Mitchell 'Short- and Long-run Performance of Australian Share Buy-backs' Update of Unpublished Paper, presented at AAANZ Conference (1997).

<sup>8</sup> S Ekanayake, 'Share buy-backs: An Explanatory Study of the Australian Experience' *Working Paper Series No. 9422* (Graduate School of Management, Deakin University, 1994).

<sup>9</sup> G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

necessary procedural steps, and duplicate regulation elsewhere in the Law'.<sup>10</sup> This is also supported by Harris and Ramsay, with specific emphasis on the requirement for directors' solvency declaration as a major deterrent against effecting buy-backs.<sup>11</sup> The Corporations Law Simplification Task Force suggests that the FCLSB would simplify the buy-back procedures as it 'removes mandatory procedures involving auditors, experts, advertisements, and declarations, which are not required in most overseas jurisdictions'.<sup>12</sup> Presumably, the implication from this comment is that these procedures are redundant. A recent survey by Dharmawan, Mitchell, Clarke and Robinson investigates the impact of legislative complexity on managements' buy-back decisions.<sup>13</sup> The Dharmawan Mitchell, Clarke and Robinson study found strong support from managers in relation to: (i) the cost of compliance with and (ii) the lack of familiarity with the old legislation, as reasons for the initial conservatism towards share buy-backs.<sup>14</sup>

The objective of this paper is to consider the legislative development of share buy-backs and highlight differences in the 'old', or pre-FCLSB, Australian legislation relative to the 'existing', or post-FCLSB, amendments. In addition, the above-mentioned issue of the complexity of the old, Australian legislation is considered. Furthermore, the impact of the legislative complexity and its role in managements' buy-back decisions is evaluated. Specifically, this paper (i) compares the old relative to the existing Australian legislation; and (ii) discusses managements' opinion on the impact of the FCLSB, drawing on an empirical survey of managements' opinions, the full results of which are contained in Dharmawan, Mitchell, Clarke and Robinson.<sup>15</sup>

This paper proceeds as follows. The next section details the development and legislative framework of the Australian buy-back legislation. In the third section survey evidence of managements' opinion on the simplification of buy-back provisions is provided. Implications of the legislative development and changes in the requirements in relation

<sup>10</sup> Corporations Law Simplification Task Force, *First Corporate Law Simplification bill, Exposure Draft* (CCH, 1994) p 8.

<sup>11</sup> T Harris and I Ramsay, note 5 above.

<sup>12</sup> Corporations Law Simplification Task Force, note 10 above, p 8.

<sup>13</sup> G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

<sup>14</sup> This is considered in more detail in section headed 'Managements' Views on Australian Buy-back Legislation' below.

<sup>15</sup> G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

to buy-back activity are covered in the fourth section. A summary and conclusion is contained in the final section.

## The Legislative Framework of Australian Share Buy-Backs

### Legislative Development of Australian Buy-back Provisions

Amendments to the former *Companies Code* came into effect on 1 November 1989. They established a legislative framework for buy-backs that was similar (in concept if not procedural requirements) to the long-established legal provisions for similar transactions in the United States and the more recent provisions of the United Kingdom *Companies Act* 1981.<sup>16</sup>

Prior to the 1989 amendments, Australian companies had the capacity to effectively 're-acquire' their shares either through indirect acquisition using associate companies and/or under the reduction of share capital provisions (s123(1)) of the former *Companies Code*.<sup>17</sup> However, the administrative and legal complexity associated with the reduction of share capital provisions ensured that few companies exercised this right.<sup>18</sup> One advantage of a buy-back compared to other

<sup>16</sup> From as early as 1887, companies were not permitted to acquire their own ordinary shares. As noted above, in *Trevor -v- Whitworth* (1887) 12 App. Cas. 409, the House of Lords ruled that a company was not entitled to purchase its own shares. The statutory prohibition on companies buying back their own shares began in Australia with the enactment of the *Victorian Companies Act 1938* (s 44).

<sup>17</sup> In an attempt to by-pass this restriction, Australian companies created a variety of vehicles through which a company could 'acquire' its ordinary shares. Notable examples are the effective re-acquisition by Pioneer Concrete Services of 6% of itself through the purchase of Neoma Developments Pty. Ltd. and the purchase of an 18.9% interest in BHP by the "BHP-controlled" Beswick. These indirect repurchases of a company's shares through an associate company relied on the principle established in *August Investments Pty Ltd v Poseidon Ltd* (1971) 2 SASR 71. Lyle, note 19 below, provides a detailed discussion of the *Poseidon Case* loophole.

<sup>18</sup> Section 195 of the *Corporations Law* replaced s 123 of the *Companies Act*. The *Corporations Law* s 195(1) provided that a company, if authorised by its articles, may by special resolution and with the confirmation of the court reduce its share capital by paying off any paid-up capital that is in excess of the needs of the company. The company had to ensure to the satisfaction of the court that the interests of creditors are secured (s195(5)). See Lyle, note 19 below, for details. Recently (1 July 1988) the capital reduction provisions (s195) have been replaced by s256A, which removes the mandatory role of the court in approving reductions of capital. Furthermore, shareholder approval, authorisation and information to be provided to shareholders for (equal/selective) share capital reductions are now the same as the equivalent (equal/selective) buy-back type requirements. The role of the court is still retained in that investors/creditors now have the capability to challenge a capital reduction (s1324 injunction). This challenge can be on the grounds that the reduction (i) is not 'fair and reasonable to the shareholders as a

forms of capital reconstruction or adjustments, such as, increased borrowings, new equity raisings or a reduction of capital is that they can be implemented reasonably quickly and with a minimum of expense. Lyle notes that buy-backs provide 'a degree of flexibility and a capacity to fine-tune the company's capital structure and its debt-to-equity ratio'.<sup>19</sup>

Three papers provided the main stimulus for the initial buy-back legislative reform. The Association of Australian Stock Exchanges May 1986 discussion paper (AASE paper);<sup>20</sup> The Companies and Securities Law Review Committee discussion paper (CSLRC paper)<sup>21</sup> of June 1986 and the CSLRC report to the Ministerial Council for Companies and Securities Council in September 1987 (CSLRC report). All three papers advocated and exposed the benefits of buy-backs.<sup>22</sup> The AASE discussion paper stated that the primary question in allowing companies the power to re-purchase their own shares is not whether buy-backs provide a benefit but more of the extent of such benefits and '... whether the advantages outweigh the risk of companies abusing the power'.<sup>23</sup> Further, Lyle notes that the *Poseidon Case* principle of indirect buy-backs using associated companies (vehicles) opened a loophole for exploitation and that this, together with the argument of the lack of effectiveness of the capital maintenance rule, were major motivations for the introduction of buy-back legislation.<sup>24</sup> Following a lengthy consideration of the matter amendments were made to the *Companies Code* lifting the prohibition against buy-backs. The amendments to the *Companies Code* permitting buy-back activity were accomplished through the enactment of Part 3 of the *Co-operative Scheme Legislation Amendment Act 1989*.

whole' (s256B1(a)) or (ii) that 'it materially prejudices the ability of a company to pay its creditors' (s256B1(b)). To be valid capital reductions must satisfy the above two requirements in addition to having the appropriate shareholder approval.

<sup>19</sup> R Lyle, *Share Buy-backs* (Longman Professional, 1993).

<sup>20</sup> Association of Australian Stock Exchanges (AASE), *A Discussion Paper on the Subject of Companies Purchasing Their Own Shares* (1986).

<sup>21</sup> Companies and Securities Law Review Committee (CSLRC), *Discussion Paper No. 5: A Company's Purchase of its Own Shares* (1986).

<sup>22</sup> Companies and Securities Law Review Committee (CSLRC), *Report to the Ministerial Council: A Company's Purchase of its Own Shares* (1987).

<sup>23</sup> AASE, note 20 above, p 8. The gains in economic efficiency flowing from the removal of the buy-back provision identified by the AASE discussion paper are as follows: the task of restructuring the capital base of a company could be more flexibly accomplished; the threat of uneconomic takeover activity could be reduced; a security market with greater depth would be created, and the establishment of employee share schemes would be encouraged.

<sup>24</sup> R Lyle, note 19 above.

On 31 December 1990, the ASX released the initial listing rules regulating on-market buy-backs. Listing Rule 3V, which came into effect on 1 January 1991, provided that a company could undertake an on-market buy-back after a notice that outlined the specific matters of the buy-back was advertised in a national newspaper and lodged with the ASX. Section 206BD of the *Corporations Law* came into effect on 8 April 1991 following further changes to the ASX Listing Rules announced on 15 January 1991.<sup>25</sup>

Despite the creation of a regulatory framework enabling share buy-backs, the frequency and dollar value of share buy-backs was less than expected. The Corporations Law Simplification Task Force attributed the initial low frequency of buy-backs to the complexity of the legislative provisions and the expensive and unnecessary steps that the procedures entail.<sup>26</sup> Thus the legislation on share buy-backs was one of the issues attended to in the FCLSB.

Following the FCLSB the legislation in relation to share buy-backs was recently further amended (effective 1 July 1998) as a result of *The Company Law Review Act 1998* (CLRA). The major changes include: (i) A reorganisation and renumbering of the sections which were now moved to Division 2 of Part 2J.1 (ss257AA-257J) as part of the continuation of the *Corporation Law* reforms. (ii) Buy-back of redeemable preference shares has been permitted (s254J(2)). (iii) A new requirement has been introduced that the buy-back does not materially prejudice the company's ability to pay its creditors (s257A(a)). (iv) The necessary requirement of a court confirmation for share capital reductions has been removed and capital reductions now have the same requirements for shareholder approval, authorisation and information to be provided to shareholders as the equivalent buy-back. (v) 'Odd-lot' buy-backs are replaced by 'minimum holding' buy-backs (which have been defined in reference to the listing rules concept of a marketable parcel). The concept of dealing in odd-lots is no longer relevant as a result of the introduction of the CHESSE ASX electronic trading system.

### **Details of Existing Legislation on Share Buy-backs**

#### **Corporations Law**

A buy-back is currently defined by the *Corporations Law* as 'the acquisition by the company of shares in itself' (s9). Legal requirements for

<sup>25</sup> The *Corporations Law* replaced the previous *Companies Code* in 1989.

<sup>26</sup> Corporations Law Simplification Task Force, note 10 above.

share buy-backs are provided in Division 2 of Part 2J.1 (ss257AA-257J) of the *Corporations Law*. Five types of share buy-backs are permitted:

**On-market buy backs:** On-market buy-backs are on-market purchases at prices no greater than 5% above the average cost of the last sale price recorded on the ASX for each of the last five days on which the shares were traded (ASX Listing Rule 7.33).<sup>27</sup>

**Selective buy-backs:** Selective buy-backs are off-market repurchases made by a company where the shares are acquired from specified shareholders at a specified price.

**Employee share scheme buy-backs:** Employee share scheme buy-backs are off-market repurchases of shares from employees who initially acquired their shares through employee share purchase plans or compensation schemes.

**Minimum holding buy-backs:** Minimum holding buy-backs are off-market repurchases of *all* of a holders shares in a listed corporation that are below a marketable parcel as defined by the relevant securities exchange.

**Equal access buy-back schemes:** Equal access (or *pari passu*) buy-back schemes are off-market purchases made by a company where each shareholder is invited to sell a fixed proportion of their ordinary shareholding at a specified price to the company.

The FCLSB amendments replaced the 'old' legislation and became effective as of 9 December 1995. The post-FCLSB rules governing share buy-backs replaced the previous 89 sections of the law (in Part 2.4 Division 4B) with 11 sections (old ss206A-206K) drafted in chronological order. The number of words was cut from about 15,000 to 2000 (ie, by about 85%). As already noted above, as part of the CLRA, further amendments to the buy-back legislation were introduced. The amendments reorganised and renumbered the previous buy-back provisions so that they are now contained in ss257AA-257J.<sup>28</sup>

Table 1 reproduces the table from s257B of the *Corporations Law* and outlines the procedural requirements as provided for in the 'existing' legislation. From Table 1 it is clear that buy-backs that affect the rights of minority shareholders, ie selective buy-backs, now have to be approved by a special resolution. This is in contrast to the other

<sup>27</sup> Previously contained in old ASX Listing Rule 3V(7)(b).

<sup>28</sup> These amendments of the *Company Law Review Act 1998* are a continuation of the reforms previously put forward in the Second Corporate Law Simplification Bill.

types of buy-backs which, at present, only have to be approved by an ordinary resolution if the buy-back limit of 10% of voting shares within the previous 12 months is exceeded. The original requirements for on-market and buy-back schemes in terms of shareholder approval (per the old ASX Listing Rule 3V(9) see Tables 2 and 3) were that approval was required only in instances where the directors were aware of an actual or proposed takeover offer or announcement.<sup>29</sup> In effect, this meant that in the majority of instances, where there was no takeover, no shareholder approval was required for these buy-back categories anyway. Further, the previous limit of 10% placed on the percentage of shares which could be bought back is removed, conditional on approval by an ordinary resolution.

Selective and equal access buy-backs have currently more stringent disclosure requirements compared with employee and minimum holding buy-back categories. On-market share buy-back disclosure requirements are contained in the ASX Listing Rule 7.29.1 (see Table 2) and are similar to the selective and equal access disclosure requirements.

### **ASX Listing Rules**

A comparison of the listing rules as of 1 July 1995 (pre-FCLSB amendments) and those that currently exist as at 1 July 1997 is given in Table 2. The comparison of the 'old' versus 'existing' listing rules demonstrates: (i) The disclosure requirements are now more uniform with the introduction of the standardised notices provided in Appendix 7B to 7E of the Listing Rules; (ii) the company's shares now must also have been traded on at least five days in the three months prior to the on-market buy-back (Listing Rule 7.29.2); and importantly (iii) a newspaper advertisement is now no longer necessary. The requirement that the buy-back price be not more than 5% above the average market price for the last five trading days for that class of securities is retained.<sup>30</sup>

### **'Old' (Pre-) -v- 'Existing' (Post-) FCLSB Legislative Requirements**

Table 3 provides a brief comparison of the procedures prescribed by the old legislation relative to the existing buy-back legislation. The FCLSB and CLRA amendments (see Table 3) extend the buy-back

<sup>29</sup> A buy-back scheme is referred to as an equal access buy-back scheme, in the existing legislation.

<sup>30</sup> Average market price calculated over last 5 days on which sales in the shares were recorded before the day of purchase (ASX Listing Rule 7.33).



power to all types of shares, as well as to all companies.<sup>31</sup> Further, conditional upon an ordinary resolution, no limit is placed on the percentage of shares which could be bought back. This eliminates the need to make other arrangements when a corporation plans to buy-back in excess of 10% of its outstanding shares for equal-access, on-market and selective buy-backs.<sup>32</sup> The FCLSB simplification also abolishes the requirement for directors to sign a solvency declaration (accompanied by auditor's report), that imposes personal liability on the directors in the event of insolvency within a 12-month period. However, the issue of insolvency is now dealt with under s588G and s1317A. Section 588G deems entering into a buy-back agreement as incurring a debt and s1317A imposes personal liability on the directors if the company becomes insolvent (suffers loss) by incurring the debt, so effectively the requirement still exists. Moreover, the new requirement of the CLRA, that the buy-back should not materially prejudice the company's ability to pay creditors (s257A(a)) further emphasises the criterion of, and concern over, solvency.

Another major simplification is the requirement for disclosure to shareholders. The old buy-back legislation specified a list of required information to be included in the notice of resolution. This included the text of resolution, reason for buy-back, takeover aspect, copy of solvency declaration, as well as a reasonableness test, ie other information known to any of the directors which 'may reasonably be expected to influence a person in deciding whether or not to vote in favour of resolution' (previous s206GD(9)). The existing requirement shifts the burden to directors in deciding what type of information is to be disclosed to shareholders, ie effectively a materiality test. It requires directors to decide and report 'all information known to the company that is material to the decision how to vote on the resolution' (s257C(2) and s257D(2)); information to accompany notice of

<sup>31</sup> The buy-back power is now applicable to all shares including, as a result of the CLRA, redeemable preference shares (s254J(2)). Prior to the FCLSB amendments, only companies with specific authority in their articles of association could buy-back shares. The intention to incorporate a buy-back authority in the articles had to be sent out as a notice, setting out specified information including: the reasons for the resolution, potential advantages and disadvantages for the directors and members and the company. The buy-back authority had to be renewed every three years, with a similar notice together with a review of any buy-backs and their effects.

<sup>32</sup> A notable example of where this occurred is the Coles Myer buy-back of the 21.45% held by Kmart. This was organised as a selective buy-back of 10% of the shares owned by Kmart Overseas Corporation directly and then the takeover of the subsidiary of Kmart (Kmart Holdings Pty. Ltd.) which held the 11.45% remainder.

meeting). It also requires 'all information known to the company that is material to the decision whether to accept the offer' (s257G; disclosure with offer) to be disclosed for equal access and selective buy-backs. A similar requirement is contained in the new ASX Listing Rule 7.29 notice (Appendix 7B) with regard to on-market buy-backs, ie 'any other information material to a shareholder's decision whether to accept the offer'.<sup>33</sup>

In addition to the above, the FCLSB amendments removed mandatory procedures involving experts reports (previously contained in ss206KD and 206KE), restriction on a share/right offer around the buy-back date and the requirement to provide documents available for inspection, as well as eliminating the differentiation between proprietary and public companies. The Corporations Law Simplification Task Force notes that the existing rules removes a number of these requirements as they were 'unnecessary procedural steps'.<sup>34</sup> Further, the existing legislation standardises the requirements relating to shareholder approval, as well as disclosure to shareholders (s257C(2); information to accompany notice of meeting and s257G; disclosure with offer) across the buy-back types. It moreover summarises these provisions in a tabular format (see s257B and reproduced in Table 1) which allows easy reference. The Task Force itself identified that the revamped buy-back legislation achieved a higher degree of uniformity. It furthermore reduced the duplication of similar provisions within the division and shortens the length of the division. In addition, the existing division provided cross-references to other parts of the law, thus avoiding replication of other parts of the *Corporations Law*, eg rights of unpaid seller, insolvency, etc.

Overall, the FCLSB simplification process shortened the buy-back provisions from 89 to 11 sections and substantially reduced the number of words. The procedural requirements are now less and the rules are more uniform across the types of buy-backs, thus the ease of compliance and cost of conducting a buy-back is correspondingly lower. The legislation is easier to read, understand and comprehend. The revamped legislation is thus considered to be less complex using the criteria of complexity as defined by Burton and Dirkis in terms of: (i) length, (ii) plain English, and (iii) cost of compliance.<sup>35</sup>

<sup>33</sup> This is slightly different to the old Listing Rule 3V(6)(h) see Table 2.

<sup>34</sup> Corporations Law Simplification Task Force, note 10 above, p 8.

<sup>35</sup> M Burton and M Dirkis, 'Defining Legislative Complexity, A Case Study: The Tax Law Improvement Project', (1995) 14 *University of Tasmania Law Review* 198.

Corporate finance experts warmly supported the introduction of the post-FCLSB buy-back provisions. Brant (BZW Australia, Associate Director of Corporate Finance) notes that the amendments 'certainly simplifies the whole process and removes a lot of the cumbersome or tiresome steps'.<sup>36</sup> Ferguson notes that the FCLSB ensures greater flexibility in the buying back of their shares.<sup>37</sup> Brokers Bain & Co. observe that in respect to the post-FCLSB legislation that 'the procedure is so simple that Australian management will no longer be able to argue the case that it is all too hard...we are going to hear a lot more about share buy-backs'.<sup>38</sup>

### Managements' Views on Australian Buy-back Legislation

A recent empirical research paper by Dharmawan, Mitchell, Clarke and Robinson investigates managements' opinion on a number of issues relating to buy-backs.<sup>39</sup> A number of results are pertinent to the current discussion and are accordingly reproduced here. The survey instrument was sent to the Chief Financial Officer, or equivalent, of 508 companies. The sample included 44 companies that had conducted share buy-backs between November 1989 and December 1995, 217 companies that were identified as having altered their articles of association in compliance with the old s206DA requirements and a further 247 companies randomly chosen from those listed between November 1989 and December 1995.<sup>40</sup>

Issues on which managements' opinion was sought included the following: (i) the motivations for effecting buy-backs, (ii) sharemarket response, (iii) preference of buy-backs relative to share capital reduc-

<sup>36</sup> S Anderson, 'More Share Buybacks Expected with New Law' *Australian Financial Review* (29 September 1995) p 33.

<sup>37</sup> A Ferguson, 'Share Buybacks to Have Easier Path' *Australian Business Review Weekly* (3 July 1995) pp 34-5.

<sup>38</sup> L Schmidt, 'Share Buybacks Latest Market Buzzword' *Age (Melbourne)* (15 May 1995) p 29.

<sup>39</sup> G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

<sup>40</sup> A total of 112 useable questionnaires were received. This represented a 'useable' response rate of 22% of the original 508 firms in the sample. An analysis of the questionnaires across the different groups of respondents reveals some differences in responses. Managers that did *not*, as compared to those that *did*, conduct a buy-back are found to be more likely to form the view that (i) the market's interpretation of the buy-back will be negative and/or (ii) that the market will not understand buy-back activity. They also generally will have stronger reservations concerning buy-back activity. This is consistent with expectations. See G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above, for further details.

tion, (iv) the impact of the recent simplification to the buy-back legislation, and (v) reasons for the current conservatism towards share buy-backs. Of specific interest to the existing issues of legal procedures and complexity are the following results.

### **Sharemarket Response to On-market Share Buy-backs**

A majority (54.5%) of respondents indicate that they considered the motivation for share buy-backs to be well understood by the sharemarket although a significant minority disagreed.<sup>41</sup> Interesting comments were made by the other 45.5% of respondents in relation to the reasons for the lack of understanding by the market (see Table 4).

From the comments summarised in Dharmawan, Mitchell, Clarke and Robinson,<sup>42</sup> and which are reproduced in Table 4, a substantial portion of managers believed that, even after five years of buy-back activity in Australia, the sharemarket either (i) did not understand, ie they are a new concept, there is a limited number and/or are too complex, or (ii) was negatively disposed towards share buy-backs. This finding partially explains the limited number of buy-backs actually conducted by Australian listed companies. Further, fourteen respondents attributed the limited information released by companies in the buy-back announcement as the reason for the sharemarket not understanding the buy-back.

### **Share Capital Reduction**

Twenty-nine-and-a-half percent of the respondents indicated they had conducted a capital reduction in preference to a buy-back. Legal complexities (30%), followed closely by ease and familiarity (26.7%), represented the most dominant reasons for this preference. Therefore, it is likely that the preference between share capital reductions and buy-backs has shifted since the introduction of the First Corporate Law Simplification Bill.<sup>43</sup> Apart from cost and taxation considerations (both 13.3%), the other reasons indicated for the preference

<sup>41</sup> Figures in parentheses denote the percentage of the total respondents who indicated support for the statement.

<sup>42</sup> G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

<sup>43</sup> One respondent established that the use of a capital reduction scheme was going to be a more cost-effective capital restructuring mechanism compared to a buy-back under the old legislative provisions. Having spent in excess of \$350,000 on matters relating to the capital reduction, the simplified buy-back provisions came into effect and the respondent firm completed the capital restructuring as a buy-back for less than \$50,000.

of share capital reduction schemes over share buy-backs were diverse and firm specific.

### **First Corporate Law Simplification Bill**

A majority (61.1%) of the respondents stated that they were familiar with the amended legislation as per the FCLSB. Further discussion on this issue is hence limited to those (61.1%) respondents who indicated familiarity. Of those respondents, 38.2% indicated a shift in their preference for share buy-backs relative to capital reductions following the amendments. However, only 26.1% agreed that the amendments to the *Corporations Law* have changed their perception regarding the merits of share buy-backs. Notwithstanding this, 46.4% of *total* respondents agreed that the amended legislation increased the likelihood of a share buy-back being undertaken.

### **Reservations Concerning Share Buy-backs**

Management were asked to indicate the reasons they believed were most appropriate in explaining the reluctance of Australian managers to utilise buy-backs (see Table 5). The largest portion (47.3%) of the respondents suggested that the reluctance of Australian managers for conducting share buy-backs was attributable to both: (i) managements' view that shareholders prefer the company to invest rather than return surplus capital and (ii) the cost of compliance. Other dominant reasons were: (iii) a lack of familiarity with the legislation (44.6%) and (iv) the perception that a buy-back was a sign of a management bereft of ideas (39.6%). Concern over directors' solvency declarations (26.8%) and complex tax provisions (37.5%) reinforce the issue of legal complexity.

### **Summary of Managements' Views**

These responses confirmed the proposition that prior to the FCLSB amendments legal complexity of the buy-back legislation was an influential deterrent to Australian managers in utilising their buy-back power. It is apparent that the amendments altered managements' attitude towards buy-backs. Many of the reservations relating to legal complexity, cost of compliance, lack of familiarity with the legislation, directors' solvency declarations and ability to raise capital around the buy-back event have been done away with following the introduction of the FCLSB (see Table 3). For a majority of the managers, the FCLSB amendments did not change their perception on the merit of share buy-backs or their preference for buy-backs relative to capital reductions, although 46.4% indicated that they would be more likely

to effect buy-backs post the amendments. Thus it seems that managers were aware of the merits of buy-backs but were reluctant to engage in such activity under the old legislative requirements primarily due to the legal complexity and cost as well as the lack of understanding and negative interpretation by the sharemarket.

### **Reservations for, Stumbling Blocks in Regard to and Level of Buy-back Activity**

From Figure 1 and Table 6 the fluctuating level and value of buy-back activity over the financial years 1990-1997 are clearly depicted.<sup>44</sup> An initial increase in 1992 following the removal of the prohibition on buy-backs and the introduction of the listing rules in 1991 can be clearly observed. However, the number of buy-backs has been somewhat subdued over the 1993 to 1994 period. In contrast, the value and number of buy-backs increases significantly over the 1995-1997 period.

A number of stumbling blocks or reservations with regard to buy-backs have been eliminated in recent years and this has contributed to the increase. First, as Harris and Ramsay suggest,<sup>45</sup> one of the reasons for the slow uptake in buy-backs, until August 1993, could be that Australian companies had been slow to learn about buy-back procedures and the advantages that they offer.<sup>46</sup> This appears partly true from the evidence in Dharmawan, Mitchell, Clarke and Robinson which finds that a significant portion of managers were concerned about negative sharemarket perceptions, lack of understanding and/or have reservations toward buy-backs due to a lack of familiarity with the old legislation.<sup>47</sup> This is notwithstanding the fact that the manag-

<sup>44</sup> The buy-backs are classified into the various financial years using the date of commencement (on-market) and the date of buy-back (off-market). The data are collected from the ASX Data Disk and ASX Announcements Database.

<sup>45</sup> T Harris and I Ramsay, note 5 above.

<sup>46</sup> The AASE paper, note 20 above, stated that it expected there to be an initial slow adoption of buy-backs. The reasoning is that it would take time for managers to become accustomed to the practice and advantage of buy-backs and Australian management have an ethos that larger companies with higher profits and asset growth are indicative of success so buy-back may not be acceptable. Harris and Ramsay, note 5 above, in fact, reject this view because of the lack of an increase in buy-back activity from 1989 to August 1993, which suggests no leaning curve effect. However, an alternative explanation is that companies did not have sufficient time to familiarise themselves with buy-back benefits and this was exacerbated by the legislative complexity and lack of buy-back activity by blue-chip companies up to that point.

<sup>47</sup> G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

ers considered themselves to be well aware of the merits of buy-back activity. The buy-back activity in Figure 1 and Table 6 support the above findings.

Second, legislative problems associated with the requirement to submit a directors' solvency declaration which imposed personal liability were clearly a major barrier.<sup>48</sup> This is especially interesting given that post the FCLSB and CLRA amendments two of the major requirements with regard to buy-backs remain concerned with solvency. These are: (i) the liability of directors on insolvency following a buy-back (through operation of s588G and s1317A) and (ii) the buy-back must not prejudice the company's ability to pay creditors (s257A(a)). Thus the pre-FCLSB solvency issue/barrier is predominantly concerned with perception of the personal liability created by signing the declaration rather the actual liability which still remains. Certainly, the onerous requirements of auditor's reports, expert's reports and advertisements that were overly procedural and prevented the buy-back being conducted smoothly were done away with by the FCLSB. In addition, the restrictions of (i) prohibiting the issuing of capital within three months of the buy-back, (ii) that the company have the power in the articles to conduct a buy-back and (iii) the limit of the buy-back to a maximum of 10% of the shares within a 12-month period were also removed. Thus, the legislative development and the simplification of the legislative provisions have largely contributed to the increase in buy-backs over the recent period.

Third, the employment of buy-backs by 'blue-chip' companies must be given some credit for the acceptance of buy-backs as a management tool by most corporations. Significantly, the first two major buy-backs by Coles Myer (in the 1995 financial year for \$586 million) and Pacific Dunlop (in 1995 for \$208.7 million and 1996 for \$259.2 million) were followed by major buy-backs involving Westpac (in 1996 for \$545.4 million and 1997 for \$182 million and \$222.9 million), the Commonwealth Bank (in 1997 for \$1001 million and 1998 for \$650 million), National Australia (in 1997 for \$1823 million), Foodland (in 1997 for \$42.6 million) and Lend Lease (in 1997 for \$56.3 million and \$42.1 million).<sup>49</sup> As Lyle states the fact that few

<sup>48</sup> Harris and Ramsay, note 5 above; G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above.

<sup>49</sup> Buy-backs are classified into financial rather than calendar years to ensure consistency with Figure 1 and Table 6. For instance the Coles Myer buy-back was conducted in July 1994 and hence included in the 1995 financial year.

blue-chip companies engaged in buy-backs in the early years was a major impediment to the acceptance of the activity.<sup>50</sup>

Fourth, while the above has all crystallised to induce increased buy-back activity, one major legislative issue remains.<sup>51</sup> This is concerning whether Australian companies should be able to reissue shares which have been bought back rather than cancelling them as currently directed under ss257H(2) and (3) of the *Corporations Law*. The alternative to cancellation is a form of treasury share system, whereby the cancelled shares can be reissued at the discretion of the company. The introduction of treasury shares would make buy-backs even more attractive and provide a further stimulus for the increase in the level of buy-back activity.

The main advantage of the treasury share system, compared to other forms of equity financing (such as seasoned public offerings, rights issues and private placements), is the comparative low cost of raising capital using treasury shares. Public offerings, rights issues and private placements as alternative forms of equity raising have relatively higher cost for meeting the corresponding legislative requirements (eg, a prospectus for all offers to the public s1018). The selling, promotion and insurance (eg, underwriting and/or placement) fees are higher and some form of underpricing (discount to market) is necessary to induce the take up of shares. Treasury shares on the other hand are sold at full market value so no discount relative to the existing market price arises and further only costs associated with the transfer of shares (eg, brokerage and stamp duty) apply.<sup>52</sup> Lyle who argues that the introduction of treasury shares would make buy-backs more attractive and effective shares the above view.<sup>53</sup> So does the ASX, who in a paper to the Companies and Securities Advisory Committee in July 1992,<sup>54</sup> argued that Australian companies should

<sup>50</sup> R Lyle, note 19 above.

<sup>51</sup> Harris and Ramsay, note 5 above, note that accounting and taxation issues are also relevant. Yet another factor that may influence the level of buy-back activity is the economic environment, eg C Ellis and A Young, *The Repurchase of Common Stock* (Ronald Press Company, 1971) indicate that a link exists between the level of buy-back activity and economic factors in the US.

<sup>52</sup> The *Corporations Law* s1017 (exceptions to the s1018 prospectus requirement) could be amended to exclude the reissue of treasury shares from the requirement of having to prepare a prospectus.

<sup>53</sup> R Lyle, note 19 above.

<sup>54</sup> Australian Stock Exchange (ASX) *A Submission to the Companies and Securities Advisory Committee that Listed Companies be Permitted to Retain Shares Bought Back pursuant to Division 4B of the Corporations Law 1989, on their Balance Sheet as Treasury Shares Available for Resale* (1992).



have the *option* of treating shares which are bought back as treasury shares.<sup>55</sup> This represented a reversal of the ASX position in the previous AASE paper.<sup>56</sup> It seems that treasury shares are the next logical step in the legislative development to encourage the utilisation of buy-backs for the effective and efficient flow of resources based on the supply and demand for capital.

## Summary and Conclusion

Legal complexity, the number of procedures and the cost of compliance were instrumental in the limited number of buy-backs under the old legislative requirements. These were the major reasons put forward by the Corporations Law Simplification Task Force for the introduction of the revamped (FCLSB) legislation.

A comparison of the old (pre-FCLSB) legislation to the existing (post-FCLSB) legislation reveals that the existing legislative provisions are easier to read, understand and comprehend, mainly through the layout and tabular format of the legislation. The procedural requirements are less and the ease of compliance and cost of conducting a buy-back is correspondingly lower. The revamped legislation is thus viewed as less complex using the criteria of complexity defined by Burton and Dirkis of (i) length, (ii) plain English, and (iii) cost of compliance.<sup>57</sup>

An analysis of a survey of managements' views confirmed the above propositions that, legal complexity of buy-back legislation, together with negative sharemarket sentiment was an influential deterrent to Australian managers against utilising their buy-back power, under the

<sup>55</sup> The ASX paper, *ibid*, claims the following advantages for treasury shares: A reduction in the cost and time delay associated with raising equity finance; the company has the option to re-issue the treasury shares at a later date to reduce debt; the sale of treasury shares would mean that share would be sold at full market value; would encourage dividend reinvestment plans, employee share and option plans; liquidity, volume and depth could be added to company shares, and it would provide assistance with corporate restructuring particularly in takeover situations.

<sup>56</sup> AASE, note 20 above. The ASX paper, *ibid*, recommended several constraints on the holding and resale of treasury shares: only fully paid shares could be held as treasury shares; no votes could be cast for these shares while held; no dividends accrue to such shares; the recommended limit on treasury shares was 20% of issued capital; notification must be made to the ASX prior to a treasury share sale; prohibition of selling treasury shares within a specified period after a share buy-back and treasury share sales would be suspended if a takeover announcement is made until after the offer period.

<sup>57</sup> M Burton and M Dirkis, note 35 above.

old legislative regime. Further, it can be concluded that the existing requirements have been a significant influence on managements' incentive to effect share buy-backs, given that many of the concerns relating to legal complexity, cost of compliance, lack of familiarity with the legislation have been done away with following the introduction of the FCLSB.

The introduction of the existing legislation, together with a number of other pertinent factors, particularly buy-backs conducted by blue-chips such as Coles Myer, Pacific Dunlop, Westpac, National Australia and the Commonwealth Banks has served to increase the awareness and acceptance of buy-backs and allowed companies and shareholders to become more familiar with and appreciate the advantages of buy-backs. The increase in the level of, and the value of buy-back activity, (Figure 1 and Table 6) over the 1995-1997 period reflects this familiarity and acceptance. It is argued that the implementation of a treasury share system would enable a more efficient and cost-effective flow of capital, encourage buy-back activity and promote increasing familiarity and acceptance of the restructuring activity.

**Table 1: Procedural Requirements for Buy-backs Under the 'Existing' Corporations Law.**

Procedure to be Followed	Employee Share Scheme			On-market			Equal Access Scheme		
	Minimum holding Buy-backs	Within 10/12 limit*	Over 10/12 limit	Within 10/12 limit	Over 10/12 limit	Within 10/12 limit	Over 10/12 limit	Selective Buy-back	
Ordinary resolution (s257C)	-	-	Yes	-	Yes	-	Yes	-	
Special/unanimous resolution (s257D)	-	-	-	-	-	-	-	Yes	
Lodge offer documents with the ASC (s257E)	-	-	-	-	-	Yes	Yes	Yes	
14 days notice to the ASC (s257F)	-	Yes	Yes	Yes	Yes	Yes	Yes	Yes	
Disclose relevant information when offer made (s257G)	-	-	-	-	-	Yes	Yes	Yes	
Cancel shares (s257H)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	
Notify ASC of cancellation (s254Y)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	

Source: s257B(1) of the Corporations Law.

\* 10/12 limit is defined as 10% of the smallest number, at any time during the last 12 months, of votes attaching to voting shares of the company (s257B(4)). Table 2.

**Table 2: Comparison between 'Old' and 'Existing' Buy-Back Listing Rules.**

Requirements	'Old' Listing Rules*	'Existing' Listing Rules
1. Types of buy-backs.	On-market.	On-market. An on-market buy-back may be conducted by an entity not subject to the <i>Corporations Law</i> (subject to consultation and compliance with ASX rules).
2. Disclosure to the exchange.	Notice to establish on-market buy-back must include (number and description of shares, maximum number acquired, reason for purchase, takeover issues, reservation of right to sell by directors, all other information of relevance to shareholders concerning the establishment or conduct of the buy-back). Copy of advertisement. Notice of meeting (takeover). Notice of extension. Notice of other types of buy-backs. Notice of cancellation.	Any notices required by the <i>Corporations Law</i> . Appendix 7B: Announcement (Variation) of Buy-back (details of the shares, maximum number/ percentage of shares to be acquired, term of buy-back, reason for the share purchase, reservation of right to sell by directors, any other information material to the shareholder's decision whether to accept the offer). Appendix 7C: Daily Share Buy-back Notice. Appendix 7D: Final Share Buy-back Notice. Appendix 7E: Equal access scheme notice.
3. Minimum trading days.	No.	At least 5 days in the three months prior to lodgement of Appendix 7B.
4. Term of buy-backs.	1-6 months.	1-6 months (commence within 3 months of the date of lodgement with ASC or shareholder approval).
5. Price ceiling on buy-backs.	Yes, not higher than 5% above the average of the last sale price recorded on the last 5 trading days.	Yes, cannot exceed 5% above average market price of the last five trading days.
6. Director related transaction.	Prohibited, unless stated in the notice.	Prohibited, unless provided in the Appendix 7B.
7. Additional rules.	Notice of on-market buy-back must be advertised in a nationally circulating newspaper, 2 days prior to the commencement.  Ordinary resolution is required where there is actual/proposed takeover.	

\* 'Old' buy-back listing rules are as covered in ASX Listing Rule 3V as at 1 July 1995 (ie, prior to the FCLSB amendments). 'Existing' buy-back listing rules are those now covered in ASX Listing Rules 7.29 to 7.36. 'Existing' buy-back listing rules came into effect 1 July 1996.

**Table 3: Comparison Between 'Old' and 'Existing' Buy-Back Legislation.**

Requirements	'Old' Legislation	'Existing' Legislation
1. Types of securities.	Ordinary shares.	All shares including redeemable preference.
2. Shareholder approval.	Yes, public company where: Buy-back scheme or on-market where takeover (ordinary resolution). <sup>*</sup> Employee where > 10% (ordinary resolution). Selective (special resolution). Private company, where: Buy-back scheme where > 10% (ordinary resolution). Employee where > 10% (ordinary resolution). Selective where > 10% (special resolution).	Yes, where: Equal access where > 10% (ordinary resolution). On-market where > 10% (ordinary resolution). Employee where > 10% (ordinary resolution). Selective (special/unanimous resolution).
3. Power in articles.	Yes.	No.
4. Limit of 10% in 12 months.	Yes, public company where: Buy-back scheme. On-market. Selective.	No.
5. Restriction on buy-back three months before/after share issue.	Yes.	No.
6. Directors' solvency declaration.	Yes.	No.

<sup>\*</sup> Shareholder approval for an on-market buy-back where takeover was required in 'old' ASX Listing Rule 3V(9).

‡ Advertisement for on-market buy-backs was required under the 'old' ASX Listing Rule 3V(5) (see Table 2).

Table 3: Continued.

Requirements	'Old' Legislation	'Existing' Legislation
7. Auditor's report on declaration.	Yes, unless: Proprietary company and < 10%.	No.
8. Expert's report.	Yes, selective by public company.	No.
9. Advertise.	Yes, unless:‡ Employee. Odd-lot.	No.
10. Disclosure to shareholders.	Yes, where: Meeting required (list of required information for each buy-back except on-market and odd-lot: text of resolution and terms of offers, reasons for buy-back, takeover aspect, likely effect of total acceptance and copy of solvency declaration and all information known to directors relevant to the resolution). Notice of cancellation. Notice of transfer of shares.	Yes, where: Meeting required (all information known to the company that is material to the decision how to vote on the resolution). Selective (unless ASC exempts). (Same as above). Selective and equal access. (All information known to the company that is material to the decision how to accept the offer).
11. Lodge buy-back documents with ASC.	Yes (solvency declaration, auditor's report, written notice specifying the buy-back).	Yes, notice of meeting where required and offer document (equal access and selective).
12. Documents available for inspection.	Yes, register of buy-backs (copy of offer, acceptance, agreement).	No.
13. Cancellation shares.	Yes.	Yes.
14. Notice of cancellation to ASC.	Yes.	Yes.

**Table 4: Comments on Sharemarket Understanding of Buy-backs.\***

	<b>Comments</b>	<b>Number of Times Stated<sup>‡</sup></b>
1.	Lack of understanding (too complex).	23 (20%)
2.	Not enough information given.	14 (13%)
3.	Negative interpretation by the market.	12 (11%)
4.	Limited number of buy-backs.	6 (5%)
5.	Relatively new concept.	5 (4%)
6.	Confusion with the US market.	1 (1%)
7.	Limited technical analysis.	1 (1%)
8.	Too much regulation	1 (1%)
	<b>Total</b>	<b>63 (55%)</b>

\* Reproduced from G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above, Table 7.

‡ Some respondents gave multiple comments on this question. All entries are number of times each comment is stated by the respondents. Percentage denotes number of times each comment is indicted relative to the total number of all questionnaire respondents (112).

**Table 5: Reasons for Managements' Reservations  
Concerning Share Buy-backs.\***

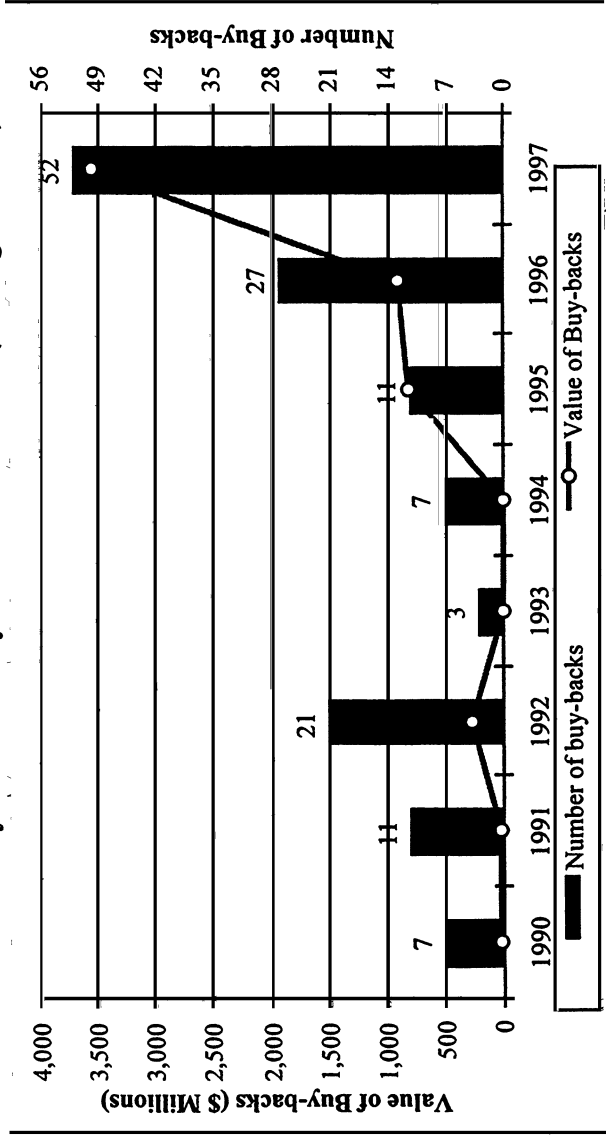
	<b>Comments</b>	<b>%‡</b>
1.	Shareholders prefer investment rather than a return of surplus capital.	47.3
2.	Cost of compliance with existing (old) regulations.	47.3
3.	Lack of familiarity with the legislation.	44.6
4.	Buy-back is a sign of management who have run out of ideas.	39.3
5.	Complex tax provisions.	37.5
6.	Shareholders prefer dividends rather than capital gains (personal tax advantage).	37.5
7.	The need for directors' solvency declarations.	26.8
8.	The restriction of buy-back provisions to ordinary shares.	17.9
9.	The prohibition of share offers and issues within three months of a buy-back.	16.1
10.	Other (not yet common practice, lack of understanding by the market, associated with poorly performing companies, viewed negatively by analysts and press, affect confidence in the firm).	9.8

\* Reproduced from G Dharmawan, J Mitchell, A Clarke and P Robinson, note 4 above, Table 7.

‡ Some respondents gave multiple responses on this question. Percentage of the number of times the statement is indicated as a reason for reservation towards share buy-backs relative to the total number of all questionnaire respondents (112).



**Figure 1**  
**Level of Buy-back Activity for Financial Year (Ending 30 June).**



**Table 6: Number, Value and Volume of Buy-back Activity.**

Financial Year (ending 30 June)	Number of Buy-backs	% Increase from Year	Value of Buy-backs (\$ Million)	% Increase from Year	Volume of Buy-backs (# Million)	% Increase from Year
1990	7	-	18	-	16	-
1991	11	57	31	74	64	312
1992	21	91	272	770	28	-56
1993	3	-86	11	-96	2	-94
1994	7	133	4	-63	41	2500
1995	11	57	812	20,221	234	463
1996	27	145	906	11	200	-14
1997	52	93	3,544	391	529	265

Source: Reconstructed from Australian Stock Exchange Buy-back Announcements and ASX Data Disk.