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I CONTRIBUTI SONO ANONIMIZZATI PRIMA DELL'INVIO AI VALUTATORI. LE SCHEDE DI VALUTAZIONE SONO INVIATE AGLI AUTORI PREVIA ANONIMIZZAZIONE.

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Cash-settled corporate equity derivatives. The relationship between disclosure rules and decoupling phenomena.

Introduction

One of the key principles of modern company law theories is that ownership of shares is a meaningful concept which customarily conveys a standard set of rights as well as certain duties and obligations, such as that of disclosure. Some of these rights, including dividends and payments in liquidation, have a purely economic nature. On the contrary, others are not strictly monetary, such as director fiduciary duties, rights to bring suit and inspect corporate records and, last but not least, voting rights.

Referring to the latter, it has been said that “*the vote is the source of shareholders’ power*” ⁽¹⁾. This right must therefore be assigned proportionately amongst common shareholders relative to their share ownership. In doing so, economic incentives are matched with voting rights, consequently reducing agency costs ⁽²⁾.

Indeed, according to the standard contractual theory of corporations ⁽³⁾, shareholders – who, as owners, have a real incentive to increase firms’ value – are vested with the power to oversee and potentially remove all members of the company’s management. Research and empirical studies also show that a disparity between voting powers and economic interest in corporations may result in a reduction in the value of the firm ⁽⁴⁾.

¹ H.T.C. Hu and B. Black, ‘The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership’ (2006), 79 S. Cal. L. Rev. 811, 814.

² F.H. Easterbrook and D. R. Fischel, ‘Voting in Corporate Law’, J.L. & Econ (1983) 395, 408.

³ See, *ex multis*, F.H. Easterbrook and D. R. Fischel, ‘Voting’, in *The Economic Structure of Corporate Law* (Harvard University Press, London 1991).

⁴ See, *e.g.*, P. A. Gompers, J. Ishii and A. Metrick, ‘Extreme Governance: An Analysis of the Dual-class Firms in the United States’ (2008) 1, 3, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=562511> accessed 31 October 2013.

As noted by eminent scholars ⁽⁵⁾, the derivatives revolution in finance – especially the increased use of (total return) equity swaps on listed shares ⁽⁶⁾ and other cash-settled equity instruments ⁽⁷⁾ privately negotiated (“over the counter” or “OTC”) ⁽⁸⁾ as well as the growth of the stock-lending market ⁽⁹⁾ ⁽¹⁰⁾ – offers quick, low-cost and low-transparent tools to decouple economic ownership from voting power. This possibility is also increased by the presence of a large number of sophisticated and lightly regulated hedge funds ⁽¹¹⁾ managing trillion dollar plus pools of assets.

⁵ H.T.C. Hu and B. Black *supra* note 1, 814; *ID.*, ‘Hedge Funds, Insiders and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership’ (2007) 1, 3, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=874098>, accessed 31 October 2013; *ID.*, ‘Equity and Debt Decoupling and Empty Voting II: Importance and Extensions’ (2008), 156 *U.Pa.L.Rev.* (2008) 625, 628. See, also, M. Kettunen and W.G. Ringe, ‘Disclosure Regulation of Cash-Settled Equity Derivatives – An Intentions-Based Approach’ (2011) 1, 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1844886> accessed 31 October 2013.

⁶ Equity swaps are also referred to as contracts for difference (CfDs) in the UK economic and legal literature. More precisely, CfDs do not provide for any interim payment but only for an exchange of cash flow at maturity. Equity swaps and CfDs may be referenced to several types of underlying but, for the purpose of the present article, reference is only made to derivatives written on listed shares (so-called equity derivatives).

⁷ Cash-settled derivatives are instruments where, at maturity or upon the occurrence of other termination events, settlement is carried out through the payment of the net change in the value of the underlying shares without any physical delivery of the shares.

⁸ Which means outside the regulated markets or other trading facilities.

⁹ See R. Aggarwal, C. Saffi, and J. Sturgess, ‘Does Proxy Voting Affect the Supply and/or Demand for Securities Lending?’ (2010) 1, 3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1688993> accessed 31 October 2013.

¹⁰ At least in certain jurisdictions.

¹¹ For completeness, European Parliament and Council Directive 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L 174/1, has introduced a legal framework regulating the activities of the managers of both hedge and other alternative funds.

As a consequence, these decoupling techniques, which have been called “new vote buying”⁽¹²⁾ or “new decoupling”, have undermined the abovementioned theories and made the foundational assumption of the so-called one-share-one-vote principle⁽¹³⁾ no longer valid, reliable and applicable⁽¹⁴⁾.

That said, in certain cases, such decoupling techniques have allegedly been used to exercise influence or acquire creeping control over listed companies without transparency, in breach of the laws and regulations that would have required the disclosure of significant shareholdings and, where applicable, the launch of mandatory public tender offers. Such a phenomenon may put at risk the information efficiency, integrity and liquidity of the market for the corporate control as a whole, on the one hand, and the functioning of the corporate governance system of the relevant issuers, on the other.

In light of the above, the article analyses the new vote buying phenomenon, with a focus on the role and use of cash-settled equity derivatives. Furthermore, it will cover the costs and benefits related to the application of a mandatory disclosure regime to such instruments. On the basis of the outcome of such assessment, I support the argument that a greater transparency regime regarding holding of equity swaps and other cash-settled equity derivatives is needed in order to root out (or more likely reduce) the abuse of such instruments.

The article is organised as follows.

Chapter 1 offers an overview of the structure of certain cash-settled equity derivatives and of decoupling phenomena.

¹² H.T.C. Hu and B. Black *supra* note 1, 816.

¹³ According to such principle, it is not [*generally*] possible to separate the voting right from the equity interest and someone who wants to buy a vote must buy the stock too. The same line of interpretation is followed by H.T.C. Hu e B. Black *supra* note 1, 811. According to these authors, “*corporate law generally makes voting power proportional to economic ownership. This serves several goals. Economic ownership gives shareholders an incentive to exercise voting power well. The coupling of votes and shares makes possible the market for corporate control. The power of economic owners to elect directors is also a core basis for the legitimacy of managerial authority. Both theory and evidence generally support the importance of linking votes to economic interest*”.

¹⁴ F.H. Easterbrook and D. R. Fischel (n 2) 410.

In Chapter 2, I analyse the current European legal framework on disclosure of major and potential holdings as set forth by Directive 2004/109/EC (the Transparency Directive) ⁽¹⁵⁾ as well as the measures proposed or adopted by the European Institutions and the United Kingdom aiming at extending such regime to cash-settled equity derivatives.

Chapter 3 describes how European as well as UK disclosure rules deal differently with a structure commonly used in the market for acquisition finance purpose. It explains the differences in terms of transparency and reporting obligations and shows, pursuant to certain conditions, how such structure may be kept hidden, leading to opaque and non-transparent financial markets.

Chapter 4 concludes.

1. Decoupling phenomena and cash-settled equity derivatives

1.1 Reasons for the existence of cash-settled equity derivatives

Cash-settled equity instruments are primarily used for purely economic and financial interests. These include (i) hedging strategies where, in order to prevent losses if the value of a target asset decreases, an investment is made in the opposite movement of the value of the target asset and (ii) speculation strategies, which aim to profit from the fluctuations in the price of a target asset.

Indeed, derivatives in general, including cash-settled equity derivatives, span across a monumental business area which is often vital to the efficient functioning of the market, especially for capital raising, financing, risk management and hedging purpose. In this respect, it should be noted that since the early 90's cash-settled derivatives have become a market standard for both institutional and retail investors. This is due to the fact that most investors are only interested in the price performance of the equities and do not intend to switch into a physical equity position after the derivative instrument has expired.

¹⁵ European Parliament and Council Directive (EC) 2004/109 of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L 390/38.

Moreover, cash settlement may increase market efficiency and liquidity given that, for example, (i) clearing and settlement risks are reduced to the timely payment of the price difference without any need to physically transfer the underlying shares, (ii) there are no minimum trading sizes, and (iii) preferential tax treatment applies to cash-settled instruments in certain jurisdictions.

Nevertheless, due to their particular features, cash-settled equity derivatives may also be used to acquire creeping control through the building of hidden stakes or toeholds and to influence issuers' corporate governance systems. Indeed, even if, from a purely legal sense, cash-settled equity derivatives do not give direct access to the voting rights attached to the underlying shares, they can still be structured so as to cause severe economic pressure for one party to transfer securities to the other or to act according to the counterparty's will.

1.2 *Old and new decoupling techniques*

The theoretical possibility of decoupling economic ownership and voting rights does not entirely depend on the derivatives industry and therefore is not a completely new concept in international capital markets.

Certain commonly used techniques ⁽¹⁶⁾ have been sometimes associated with potential benefits to the markets. These, *inter alia*, include (i) dual class common stock structures, in which one class, usually held by insiders ⁽¹⁷⁾, has high voting power while a second class has no or low voting power and is sold to outside investor, (ii) pyramidal ownership structures, particularly common in certain countries of mainland Europe ⁽¹⁸⁾, where insiders control the top company in the pyramid and (iii) circular ownership structures with insiders controlling a so-called pivotal company (hereinafter the "old decoupling techniques").

¹⁶ The analysis of the functioning of such techniques goes well beyond the scope of this article. For a thorough assessment of these points, see H.T.C. Hu and B. Black (n 1) 858.

¹⁷ By the term insiders reference is mainly made to shareholders and directors of listed companies.

¹⁸ *E.g.* Italy.

Indeed, it has been contended that the ability to maintain control over the companies through the use of the old decoupling techniques may, *inter alia*, make insiders more willing to issue new equity capital (without being diluted) in order to pursue growth opportunities. This, in turn, benefits the relevant company and the financial markets as a whole.

Nevertheless, the key aspect of the aforementioned tools is that they are usually regulated under corporate law principles and disclosed to the public and the market *ex ante* (*i.e.* before entering the transaction). Therefore, investors know what they are getting and (hopefully) pay an appropriate discounted price for non-controlling or low voting power shares or securities.

Conversely, these justifications cannot usually be applied to the new vote buying techniques which are often hidden and undisclosed. In this respect, the exact scale of the abuse of cash-settled equity derivatives is unknown.

Before describing this phenomenon in detail, it is worth focussing on some common terminology, as introduced by eminent scholars ⁽¹⁹⁾, which describes the core functional elements of the new decoupling techniques ⁽²⁰⁾.

In particular, we will refer to the notion of voting rights, which can be defined as either the formal right to vote (*i.e.* the legal right to vote under company laws or regulations) or the informal right to vote (*i.e.* not set forth under any company law or regulation principles), which is the power to instruct someone how to vote.

Economic ownership can be defined as the economic and financial return on shares (regardless of voting rights) which can be gained either through the holding of the company stocks as well as derivatives (*e.g.* options, futures, equity swaps, *etc.*) and other contractual rights (*e.g.* rights under a stock loan agreement), whose performance is directly linked to the performance of the underlying shares (the “linked assets”). Therefore, such economic ownership can

¹⁹ See H.T.C. Hu e B. Black (n1) 823-826.

²⁰ See E. De Nardis and M. Tonello, ‘Know Your Shareholders: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests’ (2010) 1, 3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1648526>, accessed 31 October 2013.

be positive, when it is directly linked to the returns on shares, or negative in the opposite scenario.

Related to the above is the concept of net economic ownership which is the sum of the combined economic ownership of shares and other linked assets and can be positive, negative or neutral.

On the basis of the concepts above, we may now identify the meaning of empty voting and hidden (morphable) ownership that give rise to the new vote buying phenomena. As pointed out by eminent authors ⁽²¹⁾, the former refers to events where the voting rights held by a person substantially exceed his or her net economic ownership. The latter instead indicates the holding of economic ownership (usually not covered by disclosure rules) exceeding the holding of formal voting rights, which is often coupled with the possibility to obtain the possession of additional voting rights, both informally and formally (*i.e.* acquiring the relevant shares).

1.3 *The economic structure of cash-settled equity derivatives*

To better understand empty voting and hidden (morphable) ownership phenomena, it may be worth describing the structure of one of the most common types of cash-settled equity derivatives, known in the finance jargon as cash-settled total return equity swap ⁽²²⁾.

Cash-settled equity swaps are agreements that seek to replicate the positions of a long and short investor in a particular stock ⁽²³⁾ and are concluded between two parties. The first party (*i.e.* the equity amount receiver) is interested in the increase in the value of the underlying stock (*i.e.* the long position) ⁽²⁴⁾. The second party, that may be a bank

²¹ See H.T.C. Hu e B. Black (n 1) 823-826.

²² For the analysis of the terms and conditions of the cash-settled total return equity swap, and, more generally, of the other derivative instruments, I will make reference to the clauses and definitions provided by the International Swaps and Derivatives Association (ISDA) which has created the contractual frameworks most commonly used in the market (*i.e.* ISDA Master Agreement versions 1992 and 2002).

²³ D. Zetsche, 'Hidden ownership in Europe: BaFin's Decision in Schaeffler v. Continental' (2009), EBOR 10 (2009) 115, 146.

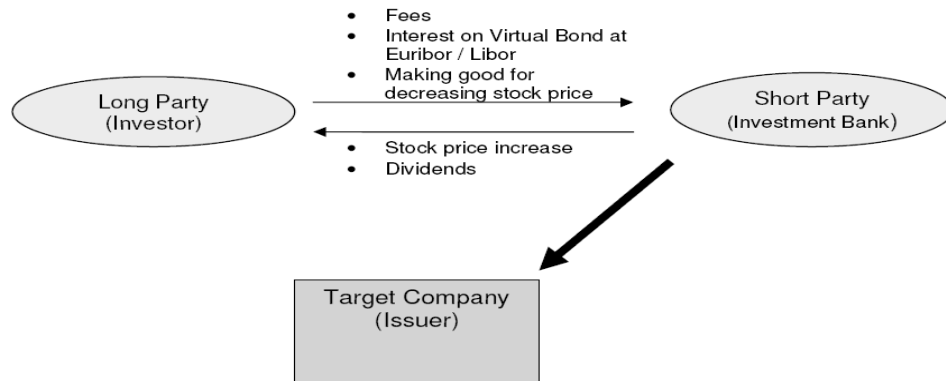
²⁴ In other words, the party acquiring a long position over the reference shares benefits from any appreciation in the market value of those shares, bearing losses in the opposite scenario.

or another financial intermediary (*i.e.* the derivative dealer or the equity amount payer), conversely bets on the decrease in the reference price of such stock (*i.e.* the short position). On this specific point, it should be noted that one of the main features of cash-settled equity swaps is that the long party is able to take an economic exposure to a reference share at a fraction of the cost of directly acquiring the underlying share itself ⁽²⁵⁾. This enables investors to enter into positions on a leveraged basis without having to fund the full purchase price.

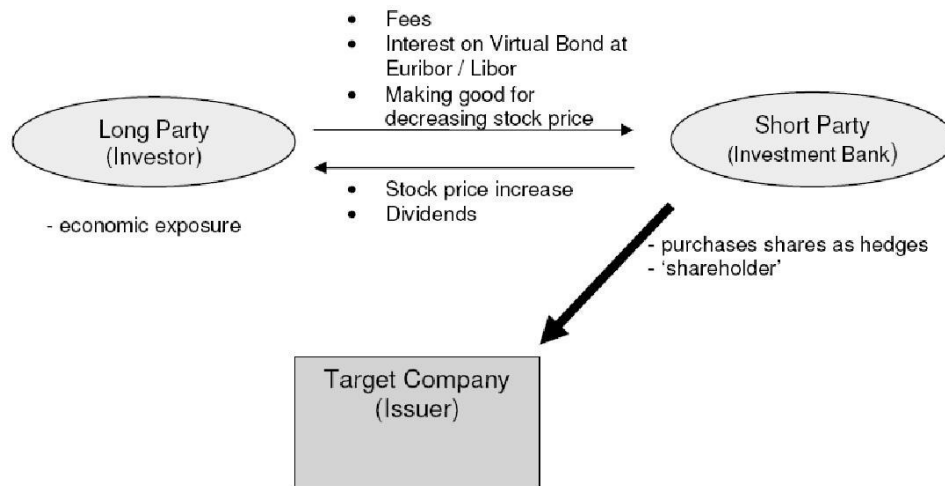
As explained in the graph below, if the shares' price increases, the party acquiring the long position receives from the counterparty an amount equal to the increase in the value of the shares in the relevant period plus any distribution (*e.g.* paid dividends). In the opposite scenario, the derivative dealer generally receives an amount equal to the sum of (i) the absolute value of the decrease in the value of the shares in the relevant period, (ii) interests stemming from a virtual bond ⁽²⁶⁾ whose yield refers to state bank lending terms (*i.e.* EURIBOR or LIBOR plus spread) and (iii) an arrangement fee. Given the nature of cash-settled instruments, it is clear that there is no required physical delivery of the underlying shares at the maturity date.

²⁵ According to certain market researches, cash-settled equity swaps generally require the investor to pay an initial margin ranging between 5 per cent. and 10 per cent. of the reference share's value. See Financial Services Authority, Disclosure of Contracts for Difference, Consultation and draft Handbook Text 07/20 (2003) <http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf> accessed 12 October 2013.

²⁶ The notional amount of the bond usually equals the amount of the underlying of the swap.



That said, it should be noted that derivative dealers are not necessarily interested in speculative business. Therefore, they will tend to hedge their short positions against the risk of positive performance of the underlying shares which would give rise to their payments obligations under the swap. As shown by the graph below, such hedging strategy may be carried out either by investing in further cash-settled equity swaps and other derivatives referenced to the same underlying stock or by directly acquiring the shares (the so-called hedging or matched shares) so that losses (gains) on the equity swap are offset by gains (losses) on these shares.



The abovementioned hedging strategies effectively abolish the risk of the fluctuation of the shares' price borne by the derivative dealer. Moreover, the hedging shares will be commonly locked into the equity swap structure and therefore taken out of the market. This is due to the fact that a natural hedge (*i.e.* direct purchase of the underlying shares) is often operationally and administratively the easiest way of hedging ⁽²⁷⁾. Therefore such shares will be held by the dealer to cover its exposure till the maturity or early termination of the swap.

1.4 Analysis of the decoupling phenomena

1.4.1 Empty voting

As anticipated above, investors (both outside investors and insiders) can have a large voting stake in an issuer with a zero or even negative net economic ownership of the company. This situation,

²⁷ Especially in those cases where the equity swap involves a substantial amount of shares of a single company, hedging with matched shares may be the only commercially sound choice for the derivative dealer, as alternative hedging strategies are likely to be limited and more expensive.

which clearly departs from the traditional “one share-one vote” principle⁽²⁸⁾, is known in the legal jargon as empty voting⁽²⁹⁾.

One core strategy for empty voting, usually adopted by outside investors, is to acquire shares of a company while simultaneously hedging the related economic exposure through a short position in a cash-settled equity derivative (*e.g.* a short equity swap position, a short position in a future contract or a short call option). Similarly, empty voting may be used in the context of strategic transactions such as mergers, where, for example, the positive vote of the target/bidder company’s shareholders is required to complete the acquisition. In these circumstances, either the target company or the bidder may try to influence the deal by acquiring bidder and target’s shares and simultaneously hedging their economic exposure to the performance of these shares through cash-settled equity derivatives⁽³⁰⁾.

Insiders may often wish to retain formal ownership of voting rights, hence reducing the economic risks linked to the performance of the shares. This aim can be achieved through a combination of stock ownership and a short equity swap position or a zero-cost collar involving the purchase of a put option (to limit downside losses) and

²⁸ See Deminor, ‘Application of the one share – one vote principle in Europe’ (2005), <<http://deminor.org/articles.do?id=3479>>, and G. Ferrarini, ‘One Share - One Vote: A European Rule’ (2006), ECGI - Law Working Paper No. 58/2006, 1 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875620 accessed 31 October 2013.

²⁹ For the purpose of this article we exclusively focus on the empty voting scenarios due to the use of cash-settled equity derivatives and not to the old decoupling techniques.

³⁰ An example of empty voting in the context of a merger is the Perry Corporation-King Pharmaceutical-Mylan Laboratories case dated 2004. Perry Corporation owned a large stake in King Pharmaceuticals and Mylan Laboratories agreed to acquire the latter in a stock-for-stock merger subject to shareholders’ approval. If the merger was going to be signed, Perry would have made a 28 million dollar profit but, after the merger was announced, Mylan’s shares sharply dropped. Therefore, Perry acquired a 9.9% stake in Mylan in order to vote in favour of the deal and simultaneously hedged its exposure through a short position in an equity swap, shedding the economic ownership of Mylan shares and keeping the voting rights. For further details, see H.T.C. Hu and B. Black (n 1) 829.

the sale of a call option (thus reducing potential gains above the strike price of the call) ⁽³¹⁾.

In light of the above, the key concern raised by empty voting is that empty voters, having a zero or even negative net economic ownership, do not bear any economic risk linked to the performance of the underlying shares. Therefore, they may tend to vote according to their personal targets which may significantly differ from those of other shareholders or of the company as a whole. Following this line of interpretation, due to the separation between voting rights and economic interest, empty voters may willingly approve certain transactions benefiting themselves even if their decisions would harm the company's interest and value.

1.4.2 Hidden (morphable) ownership

In the opposite scenario of hidden (morphable) ownership, investors (including insiders) hold greater economic interest than voting ownership, together with the possibility to indirectly exercise additional voting rights and/or acquire further shares when needed.

In this respect, it may be argued that it is frequently the expectation ⁽³²⁾ of a long swap equity holder that the derivative dealer would “ensure” that the shares are available to be voted by its client and/or sold to the client upon termination of the contractual relationship.

Indeed, with reference to the indirect exercise of voting rights, derivative dealers generally have no economic exposure to the issuer and no interest in exercising the voting rights attached to the hedging shares. However, they do usually tend to have an interest in

³¹ In this structure, the call strike price is usually higher than that of the put option, thus limiting the economic exposure to the range between the put and call strike prices. Moreover, in a zero-cost collar, the proceeds from selling the call equal the cost of the put.

³² Please note that such an expectation reflects a market practice but it is not legally enforceable. In this respect, in the 2011 ISDA Equity Derivatives Definitions, under Section 24.4 (*Hedging Activities*), it is stated that “each Party or its Affiliate or agents is not holding the Hedge Positions, if any, or engaging in the Hedging Activities, if any, on behalf or for the account of or as agent or fiduciary for the other Party, and the other Party will not have any direct economic or other interest in, or beneficial ownership of, any such Hedge Positions or Hedging Activities”.

maintaining the relationships with their clients and therefore, they may be willing to exercise their voting rights according to the *desiderata* of their counterparty, which could *de facto* exercise such voting rights. The result is an indirect influence over the corporate governance system of the relevant issuer.

Moving on to the second aspect of hidden (morphable) ownership, it is not unlikely that hidden owners will have the option to physically purchase the underlying shares which are held for hedging purpose by the derivative dealers and are therefore taken out of the market.

This is because the derivative dealers may find it more efficient and economically profitable to transfer such shares to the long party at the maturity date of the swap or even earlier ⁽³³⁾, rather than selling them in the market. This is because large equity positions may be difficult to dispose of at favourable economic terms in public trading ⁽³⁴⁾. The physical delivery of the shares could be achieved by renegotiating the derivative's contractual provisions, by changing the cash settlement methodology to physical settlement. Similarly, this result can be achieved by transferring the underlying shares outside of the contract through one or more transactions on the market and without amending the relevant settlement terms.

As a result, cash-settled equity swaps may enable swap holders to comfortably secure a block of shares (*i.e.* the shares held for hedging purpose by the derivative dealer), which can be expected to be sold when the swap is wound up or to be tendered in a takeover bid without giving rise to any prior disclosure of their identity ⁽³⁵⁾. Indeed, such

³³ *E.g.* upon the launch of a takeover bid by the long party under the cash-settled equity swap.

³⁴ Indeed, the sale on the market of a substantial amount of shares would likely result in a downward pressure on the relevant prices, thus creating a net loss for the derivative dealers. For the sake of completeness, it should be noted that such risk may be significantly diminished in the event that the derivative contracts entered into among the parties provides, in favour of the derivative dealer, a so-called averaging-out mechanism. More precisely, according to such structure, the cash flows of the derivative are determined taking into account the weighted average price received by the intermediary in order to dispose of the matched shares. As a result, the divestment risk is partly passed on to the client.

³⁵ A famous example of hidden (morphable) ownership is the Ithaca (Custodians) Ltd v. Perry Corporation case dated 2001. In June 2001, Perry gave notice that it was no longer a major shareholder of Rubicon, a New Zealand public company,

positions remain undisclosed unless (and until) the derivative is physically-settled.

1.5 *The debate around the need for an enhanced disclosure regime*

1.5.1. *Introduction: brief overview of the reasons supporting mandatory disclosure in general*

In light of the description of the decoupling phenomena and their potential implications on financial markets and issuers' corporate governance, it should be now evaluated whether an enhanced disclosure framework for cash-settled derivatives is needed. To do so, a cost-benefit analysis should be carried out to assess whether the potential benefits of a wider mandatory disclosure regime may outweigh the direct and indirect economic as well as policy costs deriving from such an extension. In fact, as noted by eminent scholars ⁽³⁶⁾, “*neither market regulation in general nor mandatory disclosure in particular are of value themselves*”.

According to basic economic theories, disclosure plays a fundamental role in promoting pricing accuracy which, in turn, increases market efficiency ⁽³⁷⁾. Indeed, it is commonly said that

having sold its stake. One year later, Perry suddenly disclosed a 16 per cent. stake in Rubicon, due to the purchase of 31 million shares from two investment banks, Deutsche Bank and UBS Warburg, just before the annual general meeting. This situation was due to the fact that in 2001 Perry sold 31 million shares to the two abovementioned derivatives dealers and simultaneously took the long side in two cash-settled equity swaps entered into with the latter. As a result, the economic ownership of Perry has never changed but it was not subject to disclosure since the equity swaps fell outside the New Zealand disclosure regime. When Perry needed the voting rights for the annual general meeting, it terminated the two cash-settled equity swaps and bought the matched shares held for hedging purpose by the derivative dealers. For more information on this case see *Perry Corporation v. Ithaca (Custodians) Ltd* [2004] 1 NZLR 731.

³⁶ See T. Baums and M. Sauter, ‘Anschleichen an Übernahmeziele mit Hilfe von Aktienderivaten’ (2009), 173 ZHR 454, 459.

³⁷ According to longstanding economic theories, there are three different forms of market efficiency: (i) weak form if the share prices (only) reflect all the information deriving from historical share prices; (ii) semi-strong if security prices reflect all publicly available information about a company; (iii) strong if prices reflect all information, not only public, but also private, inside information. See, *ex*

markets are more or less efficient depending on the speed by which a particular piece of information is factored in the share prices ⁽³⁸⁾. In other words, efficient markets are those where prices fully and promptly reflect the “available” data, to the extent that the marginal costs do not exceed the benefits of acting on such information ⁽³⁹⁾.

Efficient markets are also characterised by a high level of liquidity, since, as pointed out by eminent scholars, investors will trust the system and will be in a position to confidently make informed investment decisions, “*to the extent that share prices are efficient, in the sense of reflecting all available information*” ⁽⁴⁰⁾.

As a result of such investor confidence, corporates would benefit from a reduced cost of capital.

That said, it is questionable whether such disclosure requirements should be made mandatory or, instead, should be left to the self-initiative of the market participants.

In this respect, opponents of mandatory disclosure generally rest on the concept of “natural” market efficiency. According to this concept, (high quality) corporations in search of capital are strongly incentivised to provide adequate disclosure by the very nature of the capital markets in order to distinguish themselves from (lower quality) competitors and benefit from a reduced cost of capital. In other words, non-transparent issuers will pay the price of inadequate disclosure in the form of higher costs of funding ⁽⁴¹⁾. This is because, according to these theories, a lack of transparency will induce rationale investors to undervalue non-disclosing companies and consequently discount the prices of their securities to the benefit of other disclosing and “virtuous” corporations.

multis, E. F. Fama, ‘Efficient Capital Markets: A Review of Theory and Empirical Work’ (1970), 25 *Journal of Finance* 383, 384.

³⁸ See, *ex multis*, F. H. Easterbrook and D. R. Fischel (n2) 410.

³⁹ See M. Jensen, ‘Some Anomalous Evidence Regarding Market Efficiency’ (1978), 6 *Journal of Financial Economics* 95, 100.

⁴⁰ J. R. Macey, ‘Efficient Capital Markets, Corporate Disclosure and Enron’ (2004), 89 *Cornell Law Review* 394, 394 *et seq* and R. Gilson and R. Kraakman, ‘The Mechanisms of Market Efficiency’ (1984), 70 *VA. L. REV.* 549, 560.

⁴¹ See, *ex multis*, F. H. Easterbrook and D. R. Fischel, ‘Mandatory Disclosure and the Protection of Investors’ (1984), 70 *VA. L. REV.* 669, 683. On the same line, B. Banoff, ‘Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415’ (1984), 70 *VA. L. REV.* 135, 176–84.

Various economic and behavioural objections have been raised to the theories above. First, proponents of mandatory disclosure state that the very nature of information prevents its optimal supply. Since information can qualify as a public good ⁽⁴²⁾, research and data tend to be provided below the optimal level.

Indeed, disclosure by corporations may benefit actual or potential competitors, creditors, suppliers and prospective investors who will not pay any consideration for such an advantage (*i.e.* they are free-riders). In fact, the costs will only be borne by the disclosing firm itself ⁽⁴³⁾.

In such a situation, an externality arises ⁽⁴⁴⁾ and firms will be discouraged from disclosing because they would not be compensated for the benefits that other market participants enjoy. As a result, absent any form of mandatory transparency, there will be a sub-optimal amount of information publicly available and able to be reflected in the share prices, with repercussion on market efficiency and liquidity. Mandatory disclosure can help overcome these problems by subsidising research costs to provide a greater quantity and a better quality of information ⁽⁴⁵⁾.

⁴² As pointed out by eminent commentators, “the key characteristic of public goods is the non-excludability of users who have not paid for it”. Moreover, “because people can free ride on others’ payments, they have an incentive to underpay”. The net result is that public goods tend to be underprovided. See J. C. Coffee Jr., ‘Market failure and the economic case for a mandatory disclosure system’ (1984), 70 VA. L. REV. 717, 728-729.

⁴³ As noted by eminent scholars, potential competitors will use the disclosed information to “evaluate their position vis-à-vis the disclosing corporation and respond to the disclosed information” by taking appropriate countermeasures (*e.g.* entering or exiting a market, changing marketing or pricing strategy, etc.). As far as creditors and suppliers are concerned, they will benefit from increased negotiation power towards the disclosing company. Finally, potential investors will be able to better compare the disclosing corporation with other alternative investments. See Z. Goshen and G. Parchomovsky, ‘The Essential Role of Securities Regulation’ (2006), 55 Duke LJ 711, 756.

⁴⁴ In general terms, “an externality exists when the actions of contracting parties effect third parties who are not part of the contracting process and therefore cannot be compensated (or charged) for the costs (benefits) associated with their action”. See J. R. Macey (n40).

⁴⁵ See J. C. Coffee Jr. (n42) 722.

Another economic justification put forward for mandatory transparency is that the lack of such a regime would result in an inefficient use of resources and in a duplication of information research costs. Collectivisation of information minimises the social waste of resources that would otherwise result from duplicative efforts to gain the necessary data and helps ensure that the capital allocation mechanism works efficiently.

Moreover, it is also commonly accepted that companies' insiders (*i.e.* the managers) are usually prone and have specific monetary as well as reputational incentives to hide potential bad news for the purpose of maintaining or increasing the value of the relevant corporation. As a result, a sub-optimal level of disclosure is provided.

1.5.2 *Positive effects of decoupling*

According to certain studies, there are some benefits which may be associated with decoupling practises and with the lack of a disclosure regime for cash-settled equity derivatives ⁽⁴⁶⁾.

First, it has been said that, due to the separation between economic ownership and voting rights, particular types of active investors – *e.g.* hedge funds ⁽⁴⁷⁾ – may use empty voting to “*simultaneously hedge their economic exposure and influence corporate governance in underperforming corporations*” ⁽⁴⁸⁾. As a result, voting rights would move from less to better informed “hands”, thus enhancing the efficiency of shareholders' oversight. Moreover, the ability to hedge economic ownership while retaining voting rights may make insiders less averse to specific risks, and hence they would be more likely to

⁴⁶ S.K. Ripken, 'The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation' (2006), *Baylor L. Rev.* 139, 176-84.

⁴⁷ See Y. Allaire and M. Firsirotu, 'Hedge funds as “Activist Shareholders”: Passing Phenomenon or Grave-Diggers of Public Corporations?' (2007) 1, 3 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=961828> accessed 31 October 2013 and W. W. Bratton, 'Hedge Funds and Governance Targets' (2006) 1, 1 <<http://ssrn.com/abstract=928689>> accessed 31 October 2013.

⁴⁸ See H.T.C. Hu and B. Black (n 1) 818.

approve investment projects with high net present value thus benefiting the company as a whole (⁴⁹).

As far as hidden ownership is concerned, the possibility of secretly building up a stake prior to the launch of a takeover bid could be an efficient strategy for the acquirer, also taking into account that the lack of transparency surrounding the intentions or reasons for purchases and sales is a fundamental element of efficient markets.

In particular, according to these theories, the likelihood of success for a tender offer would be increased due to the prior acquisition of toeholds which could be subsequently tendered (*i.e.* a stealth takeover) (⁵⁰). For the sake of being thorough, it is also worth noting that, even in the event of failure of such offer, the raider would benefit from the prior acquisition of toeholds since the share price of the target company is likely to increase further (⁵¹).

As a general consequence, it has been argued that this situation would stimulate liquidity and improve the efficiency of the market for corporate control. Conversely, a disclosure regime covering cash-settled equity derivatives could actually reduce the incentives to put in takeover bids since bidders' strategies would be revealed and the latter would not be able to secure an hidden toehold in the target's capital at favourable economic conditions. As a result, potential investors would be more reluctant to engage in the market for corporate control, probabilities of takeovers would be reduced and costs of acquisitions would significantly rise (⁵²).

⁴⁹ See S. E.K. Christoffersen, C. C. Gezczy, D. K. Must and A. V. Reed, 'Vote Trading and Information Aggregation' (2005) 1, 1 <available at <http://ssrn.com/abstract=686026>> accessed 31 October 2013.

⁵⁰ On this topic, see G. Ferrarini, 'Share Ownership, Takeover Law and the Contestability of Corporate Control' (2000) 1, 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=265429> accessed 31 October 2013.

⁵¹ See J. Bulow, 'Toeholds and Takeovers' (1999), 107 J. Pol. Econ 427, 428 and D. Hirshleifer - S. Titman, 'Share Tendering Strategies and the Success of Hostile Takeover Bids' (1990), 98 J. Pol. Econ. 295, 298.

⁵² See Financial Services Authority (n24) Annex 2, 8.

1.5.3 *Negative effects of decoupling*

According to certain literature, there are a number of negative effects that derive from decoupling phenomena which may give rise to severe market failures.

First and foremost, it is common opinion among issuers and investors that decoupling techniques, coupled with the lack of a disclosure regime for cash-settled equity derivatives, are responsible for information asymmetry and inefficiency (⁵³).

Indeed, due to the particular structure of such instruments, the identity, intention, investment size and time-horizon of the swap's holder remains hidden for the duration of the derivative. It is also unclear whether the matched shares, commonly acquired by the derivative dealers, are held either in their proprietary trading books or, instead, in the market making accounts for sheer hedging purpose.

In this regard, irrespective of any influence on the voting rights which may be posed by an abuse of empty voting and hidden ownership, it is arguable that the identity as well as the investment size of the derivative dealers have an impact on the market. This is because, these data may be used by traders to evaluate the shares of the relevant issuer. Absent a mandatory disclosure regime, such information may be in hiding and not correctly reflected in share prices.

Moreover, cash-settled equity derivatives can have a severely adverse impact on the market for corporate control and distort issuers' corporate governance.

In fact, empty voting may allow both insiders and potential investors to exercise voting rights without disclosing their real economic exposure which could be zero or even negative. As a consequence, it is my opinion that reactions from market participants may be misled by decisions made by persons whose ultimate targets are not aligned with the company's best interests, since they do not bear any potential risk relating to the performance of the firm. In other words, other uninformed shareholders, who are unaware of the real economic positions of the derivative holders, may act based on the

⁵³ See, *ex multis*, M. Kettunen and W.G. Ringe *supra* note 5, 13 and the Financial Services Authority (n 25) 20.

(wrong) assumption that decisions adopted by empty voters aim to maximise company's profits or value.

In my view, the consequences of this situation are threefold: first, the entire voting process may be fundamentally altered. Second, if no data on the *de facto* holders of voting rights are available, then share prices will be inefficiently calculated since they will not be able to reflect such information. Finally, due to such uncertainty and market opacity, it is arguable that the more rationale of the investors will be persuaded to either discount the value of the securities issued by the entire spectrum of listed issuers (including securities issued by disclosing companies) or exit the market, thus reducing liquidity level and increasing the cost of capital (⁵⁴).

Similar concerns apply to hidden (morphable) ownership scenarios. Indeed, the possibility for derivative holders to indirectly exercise the voting rights attached to the matched shares, may result in a misrepresentation of the shareholders' base. This is because, available public information would only cover the formal legal ownership of such shares (held by the derivative dealers), without giving information about the natural person/legal entity which may *de facto* exercise those voting rights, therefore potentially acting as a real shareholder (*i.e.* the hidden owner).

Similarly, it appears undisputable to me that this mechanism would also distort the very foundations of issuers' corporate governance system. It would also increase the information asymmetry between insiders and informed traders, on the one hand, and unaware minority shareholders and uninformed market participants, on the other. Finally, it could potentially give rise to inefficient price formation since hidden information will not be correctly reflected in share prices. Investors' confidence and market liquidity would, in turn, be affected.

As per the theories relating to the alleged market benefits which would derive from the possibility to secretly acquire a toehold, they do not seem to be decisive.

Indeed, against the argument that any disclosure regime covering cash-settled equity derivatives could actually reduce the incentive to

⁵⁴ This scenario resembles the well-known "Market for Lemon Theory" conceived by G. Akerlof.

launch a bid, it may be reasonable to counter-argue that the presence of secret toeholds may actually discourage other potential bidders from competing for the takeover since they are at a disadvantage in comparison with the bidder who already owns a stake ⁽⁵⁵⁾. Following this line of interpretation, the possibility to secretly acquire a toehold, which can be expected to be converted into shares upon the launch of a takeover bid, could distort the efficient functioning of the market for corporate control by postponing or avoiding the application of the rules relating to mandatory tender offers (also in terms of offer prices). Once again, this opacity could reduce liquidity and give rise to high volatility as well as speculation since uniformed investors and market participants may be unable to efficiently react to this situation ⁽⁵⁶⁾.

2. The European and UK disclosure legal framework

2.1 The Transparency Directive

Bearing in mind the potential market failures often associated with an abusive use of cash-settled equity derivatives, it is now worth analysing how decoupling phenomena have been addressed at the European Level by European Institutions and Member States.

In this respect, the fundamental backdrop for any analysis about the disclosure regimes currently in force in the main European jurisdictions is the Transparency Directive on the harmonisation of transparency requirements in relation to information about listed issuers ⁽⁵⁷⁾.

⁵⁵ See Financial Services Authority, (n 25) Annex 2, 5.

⁵⁶ As correctly pointed out, the information asymmetries caused by hidden (morphable) ownership “means that the minority shareholders remain uninformed and unable to react to information on ownership of the company. They may for instance wish to sell stakes in a firm upon knowledge of large stake-building by insiders, but without this knowledge will be unable to act on this information”. See Financial Services Authority (n 25) Annex 2, 6.

⁵⁷ Pursuant to the Lamfalussy procedure used for the development of financial services regulation in the European Union, the European Commission has adopted a so-called Level 2 directive – Directive 2007/14/EC dated 8 March 8 2007. Finally, the Committee of European Securities Regulators (CESR) conducted Level 3 implementation procedures by publishing, on October 17, 2008, the ‘Summary of Responses to Questionnaire on Transposition of the Transparency Directive’.

By way of background, according to the preambles, one of the key aims of the Directive is to improve investor confidence and market efficiency through a harmonised transparency regime relating to all companies listed on the European Stock Exchanges. Clearly, such a statement fully supports the argument that disclosure, in general, and transparency of major holdings, in particular, should allow investors to carry out an informed assessment of a company's performance and enable investors to acquire or dispose of shares with full knowledge of any changes in the voting structure. This should, in turn, enhance investors' confidence and market efficiency.

Having said that, the European shareholding disclosure rules currently in force are only based on the real as well as potential ownership of the voting rights associated with listed issuers' shares and not on any economic exposure to the performance of the relevant shares.

Indeed, the Transparency Directive firstly requires disclosure of the acquisition or sale of voting shares where, as a result of these transactions, the proportion of voting rights ⁽⁵⁸⁾ held by an investor reaches, exceeds or falls below one of the relevant thresholds ranging between 5 per cent. and 75 per cent. of issuers' voting capital ⁽⁵⁹⁾, unless one of the relevant exemptions applies ⁽⁶⁰⁾.

⁵⁸ Article 9, Paragraph 1, of the Transparency Directive clarifies that such voting rights have to be taken into account even if the exercise thereof is suspended.

⁵⁹ Under Article 9 of the Transparency Directive, each home member State must ensure that, where a shareholder acquires or disposes of voting shares, such shareholder notifies the issuer of the quota of voting rights held as a result of the acquisition or sale where that quota reaches, exceeds or falls below the thresholds of five per cent., 10 per cent., 15 per cent., 20 per cent., 25 per cent., 30 per cent., 50 per cent., and 75 per cent.

⁶⁰ The Transparency Directive provides for a number of exemptions from the reporting requirements. Briefly, pursuant to Article 9, Paragraph 4 *et sub.*, disclosure does not apply, *inter alia*, to (i) the acquisition of shares exclusively carried out for clearing and settlement purposes, (ii) custodians, provided that certain conditions are met and (iii) the acquisition and/or disposal of voting shares carried out by the market makers providing liquidity to the market. Moreover, home member States are allowed to introduce a further exemption for voting rights held in the trading books by credit institutions and investment firms provided that such voting rights do not exceed the 5 per cent. threshold and are not exercised to influence the management of the relevant issuer.

Moreover, the notification requirements apply in the event that the relevant thresholds are crossed either upwards or downwards as a result of a change in the breakdown of voting rights ⁽⁶¹⁾. They also apply to any natural person or legal entity entitled to acquire, dispose of, or exercise voting rights in certain circumstances including shareholders agreements, stock lending, life interest, deposit, pledge and proxies to vote ⁽⁶²⁾.

The European legal framework also provides that, upon the crossing of the relevant thresholds, disclosure will apply to investors who, directly or indirectly, hold financial instruments granting a right to physically acquire the underlying shares (so-called long potential holdings). In order to fall within the scope of the reporting regime, rights to acquire shares must provide the relevant holder with the entitlement ⁽⁶³⁾, pursuant to a formal agreement ⁽⁶⁴⁾, to physically acquire voting shares ⁽⁶⁵⁾.

The second level Directive 2007/14/EC lists the types of financial instruments which, upon occurrence of the abovementioned requirements, are relevant for disclosure purpose. In particular, reference is made to physically-settled instruments such as transferable securities, options, futures, swaps, forward rate agreements and any other derivative contracts, as referred to in Section C of Annex I of Directive 2004/39/EC.

Thus, only physically-settled instruments currently fall within the reporting obligations. The rationale behind this principle is that

⁶¹ See Article 9, Paragraph 2, of the Transparency Directive.

⁶² See Article 10 of the Transparency Directive.

⁶³ Article 11, Paragraph 1, of the second level Directive 2007/14/EC clarifies that *“the instrument holder must enjoy, on maturity, either the unconditional right to acquire the underlying shares or the discretion as to whether acquire such shares or not”*.

⁶⁴ Article 11, Paragraph 1, of the second level Directive 2007/14/EC specifies that *“a formal agreement means an agreement which is binding under the applicable law”*.

⁶⁵ See Article 13, Paragraph 1 of the Transparency Directive, pursuant to which *“the notification requirements laid down in Article 9 shall also apply to a natural person or legal entity who holds, directly or indirectly, financial instruments that result in an entitlement to acquire, on such holder’s own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market”*.

allegedly only physically-settled instruments allow the relevant holder to potentially influence the relevant issuer's corporate governance system as well as impacting on the overall market efficiency. However, this is according to certain traditional longstanding theories, which some recent cases have proven to be faulty⁽⁶⁶⁾.

Finally, under the Transparency Directive no netting is allowed since the rules are intended to catch gross long positions without netting any offsetting short position.

In light of the above, it is possible to conclude that the decoupling phenomena described above fall out of the scope of the European rules currently in force.

2.2 The European debate for a review of the Transparency Directive

2.2.1 Introduction

In response to the alleged abuses of cash-settled equity derivatives previously described, an intense debate is going on amongst European Institutions on a possible review of the reporting regime currently set forth by the Transparency Directive⁽⁶⁷⁾.

The declared aim is clearly to extend the application of certain transparency obligations to include cash-settled equity derivatives.

⁶⁶ See, *ex multis*, the well known Schaeffler-Continental, Porsche-Volkswagen cases and the recent LVMH-Hermès case. For a thorough description of these cases, see D. Zetzsche, 'Continental v. Schaeffler, Hidden Ownership and European Law – A Matter of Law of Enforcement' (2008) 1, 20 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1170987> accessed 31 October 2013 and AMF Enforcement Committee, 'Décision de la commission des sanctions à l'égard de la société LVMH Moët Hennessy-Louis Vuitton' <http://www.amf-france.org> accessed 30 October 2013.

⁶⁷ See L. Enriques, 'Transparency obligations for listed companies: Scope for the modernization of the Transparency Directive?', contribution to the European Commission Conference on the Operation of the Transparency Directive 2004/109/EC, Bruxelles, 11 June 2010, available at www.consob.it, and H. Fleischer and K.U. Schmolke, 'The reform of the Transparency Directive: Minimum of Full Harmonisation of Ownership Disclosure?' (2011), 12 EBOR 121, 130.

2.2.2. ESME report and CESR consultation paper

In 2009, the European Securities Markets Expert Group (ESME) ⁽⁶⁸⁾ was requested by the European Commission to carry out an analysis on a possible extension of certain reporting requirements to cash-settled equity derivatives ⁽⁶⁹⁾.

Based on the outcome of a thorough analysis, ESME stated that synthetic transactions involving cash-settled equity derivatives are mostly used not to influence voting behavior or to acquire creeping control, but rather to increase investment possibilities for professional investors and help improve the risk profile of their investment portfolios.

Nevertheless, recent cases demonstrate that instruments originally construed for liquidity or hedging purpose can be actually used to acquire hidden toeholds in listed companies at a price influenced by the circumvention of existing transparency rules, thus jeopardizing market efficiency.

In light of the above, ESME concluded that it would be preferable to disclose all derivative positions gained through the most commonly used instruments irrespective of any consideration relating to investors' possible intentions.

The Committee of European Securities Regulators (CESR) ⁽⁷⁰⁾ recommended the adoption of a harmonised pan-European approach on major shareholding disclosure obligation ⁽⁷¹⁾. In this respect,

⁶⁸ The European Securities Markets Expert Group (ESME) was created by Commission Decision 2006/288/EC of 30 March 2006 (OJ L 106, 19.4.2006, 14).

⁶⁹ See ESME, Views on the issue of transparency of holdings of cash-settled derivatives, November 2009, available at http://ec.europa.eu/internal_market/securities/docs/esme/tdcash_en.pdf.

⁷⁰ CESR was responsible for, *inter alia*, providing advice on the implementation of the Transparency Directive. Such functions have now been taken over by the European Securities and Markets Authority created by Regulation (EU) of the European Parliament and of the Council no. 1095 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No. 716/2009/EC and repealing Commission Decision 2009/77/EC <http://www.esma.europa.eu/system/files/Reg_716_2010_ESMA.pdf> accessed 15 October 2013.

⁷¹ See CESR, Proposal to Extend Major Shareholdings Notifications to Instruments of Similar Economic Effect to Holding Shares and Entitlements to

CESR's proposal was that the disclosure regime should be extended to all types of instruments that have a similar economic effect to the holding of shares as well as to the entitlement to physically acquire those shares ⁽⁷²⁾.

In other words, according to CESR's position, disclosure should cover derivatives granting the relevant holder a positive exposure to the performance of the underlying shares irrespective of whether such instruments are physically or cash-settled. This is because it is likely that an investor with a significant long economic interest would try to influence the relevant issuer. However CESR noted that any additional regulation should not discourage the use of such instruments for legitimate financial and economic purposes.

From the above, it appears clear that the two proposals are both mainly aimed at tackling the hidden (morphable) ownership scenarios rather than the cases of empty voting.

This is because, the proposed rules only focus on instruments giving to the relevant holder an economic exposure on the underlying shares that exceeds the legal and formal ownership of the voting rights attached to such shares.

Conversely, the situations where the voting rights are exercised by an entity holding a net economic ownership equal to zero or even negative (*i.e.* empty voting) are not intended to be captured by the two proposals. A possible reason for this policy-choice is that, as stated by CESR, the issues relating to the creation of the net short positions ⁽⁷³⁾ in listed issuers should be left to the regulatory framework on short selling.

Acquire Shares, 9 February 2010, Ref.: CESR/09-1215b <<http://www.cesr-eu.org>> accessed 15 October 2013.

⁷² For a critical reconstruction, see D. Zetzsche, 'Against Mandatory Disclosure of Economic-only Positions referenced to Shares of European Issuers – Twenty Arguments against the CESR Proposal' (2010), in 11 EBOR, 231, 240 and M. C. Schouten, 'The Case for Mandatory Ownership Disclosure' (2009), 15 Stan. J. L. Bus. Fin. 127, 128.

⁷³ In a nutshell, net short positions in listed issuers can be defined as the difference between (i) the aggregate short exposure (*i.e.* the sum of all the positions, whether cash or physically-settled, negatively related to the performance of the shares) and (ii) the overall long positions (*i.e.* the sum of all the positions benefiting from a positive performance of the stock's price).

2.2.3. *The review of the Transparency Directive*

In October 2011, the European Commission published its proposal for a review of the Transparency Directive (⁷⁴). In October 2013, the Council of the European Union adopted the final text of a directive amending the transparency framework currently in force (⁷⁵). The amending Directive provides for, *inter alia*, a transparency regime for major economic positions in listed companies, with a view to enhancing market confidence and investor protection while discouraging secret stock building.

In order to achieve such a result, the disclosure obligations are extended to all instruments with similar economic effect to the holding of shares and long potential holdings (⁷⁶), thus capturing both cash-

⁷⁴ See European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC, dated 25 October 2011 <http://ec.europa.eu/prelex/liste_resultats.cfm?CL=en&ReqId=9&CB1=MARKT> accessed 12 October 2013.

⁷⁵ See Directive 2013/.../EU of the European Parliament and of the Council of amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC, dated 10 October 2013 <<http://register.consilium.europa.eu/pdf/en/13/pe00/pe00037.en13.pdf>> accessed 20 October 2013. The amending Directive is expected to come into force on the twentieth day following its publication in the Official Journal of the European Union.

⁷⁶ The definition of long potential holdings has been slightly amended specifying that the entitlement to acquire shares operates at maturity. More precisely, long potential holdings are defined as “*financial instruments that, on maturity, give the holder, under a formal agreement, either the unconditional right to acquire or the discretion as to his right to acquire, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market*”. See point 9 of the amending Directive. Even if a thorough analysis of the notion of long potential holdings falls outside the scope of this article, it should be noted that, in order to avoid the creation of an un-level playing field, also instruments giving the relevant holder the unconditional right to acquire the

settled equity derivatives and any other similar financial instruments⁽⁷⁷⁾.

The above being said, equity derivatives (which do not qualify as long potential holdings, whether cash and physically settled) and other financial instruments that have a similar economic effect (*i.e.* attribution of a long position to the relevant holder) should be aggregated to long potential holdings for the threshold crossing purpose⁽⁷⁸⁾.

Moreover, the amending Directive aims to harmonise the different national disclosure regimes currently in force in the Member States. It does so by introducing a uniform approach which requires the aggregation of the holding of shares, long potential holdings and other instruments (both physically and cash-settled) that have a similar economic effect.

The adoption of a common approach is essential to (i) improve legal certainty; (ii) increase transparency; (iii) simplify cross-border investments; (iv) reduce compliance costs for market operators; and (v) avoid potential circumvention of the reporting obligations by an abusive splitting of the aggregate long position below the different thresholds applicable to shares and other physically and cash-settled long positions⁽⁷⁹⁾. In this respect, the notification requirements should

underlying shares during the term of the derivatives (*e.g.* American options) or at certain dates during the term of the instruments (*e.g.* Asian options) must fall within the notion of long potential holdings. Also, it appears to me that in order to avoid any formalistic reconstruction of the rules, the term unconditional is to be interpreted as referring to situations where the holder can, at its discretion, decide whether or not to acquire the underlying shares, even at non-economic terms, without any required cooperation from the counterparty. Stating otherwise (*i.e.* that the term unconditional only refers to situations where the instrument is “in the money” for the holder) would result in creation of gaps in the legal framework which could be easily circumvented.

⁷⁷ Such instruments with similar economic effect are defined as “*financial instruments which are not included in point (a) [i.e. entitlements to acquire shares] but which are referenced to shares referred to in that point and with economic effect similar to that of the financial instruments referred to in that point, whether or not they confer a right to a physical settlement*”. See point 9 of the amending Directive.

⁷⁸ See point 9 of the amending Directive.

⁷⁹ The circumvention of the disclosure obligations may result from an investor holding a major shareholding equal to 4.99 per cent. in an issuer’s voting capital alongside an equal percentage resulting from the aggregation of long potential

also apply when the direct or indirect holding of voting shares aggregated with the direct or indirect holding of potential holdings or other instruments with similar economic effects reaches, exceeds, or falls below one of the relevant thresholds set forth by the Transparency Directive ⁽⁸⁰⁾. Another point to be mentioned is that, according to the amending Directive, the delta approach ⁽⁸¹⁾ should be adopted for the calculation of long positions held through cash-settled instruments with similar economic effect to the holding of shares and long potential holdings ⁽⁸²⁾. Conversely, the calculation for the other instruments should be made taking into account the maximum nominal number of underlying shares (the nominal approach). The decision to limit the application of the delta adjustment approach only to the instruments which are cash-settled appears to be based on two different reasons. *In primis*, as opposed to the physically-settled long potential holdings which give the relevant a direct unconditional right to acquire the underlying shares, cash-settled instruments only gives an indirect possibility to acquire such shares, which is dependent upon the occurrence of the conditions described above. Therefore, in such scenario, where there is only a potential (and in any case mediated) impact on the ownership structure and on the corporate governance system of the relevant issuer, the adoption of the nominal approach (i.e. the maximum number of underlying shares) would result in an overrating of the real long position held by the purchaser of the derivative. This is because, for the reasons described above, the intermediaries, who will usually be the counterparties of the derivative, would dynamically hedge their exposures, by buying and

holdings and other instruments with similar economic effects. Considering that both the baskets are below the relevant notification thresholds (i.e. 5 per cent.), an investor may hold an overall long position equal to 9.98 per cent. without triggering any reporting notification. Conversely, should the aggregation of the two baskets apply, such investor would be required to disclose the crossing of the 5 per cent. thresholds.

⁸⁰ See point 9 of the amending Directive introducing a new Article 13 (a) to the Transparency Directive.

⁸¹ The delta measures how the change in the pay-off of a derivative changes in relation to the change in price of the underlying equity.

⁸² The delta adjusted approach usually applies to options and other asymmetric derivatives since CfDs and equity swaps would normally have a delta of one, as they perfectly mirror any change in the underlying share price.

selling shares on the basis of the movement in the share prices quoted on the relevant stock exchange and of the relevant “sensitivity” of the value of the instrument. Indeed, the presence of the intermediaries, which are skilled and equipped to perform the relevant calculation, may justify the choice to apply the delta coefficient to the cash-settled instruments. In fact, in such cases, the counterparties would not be required to bear high operative and compliance costs, since the performance of any valuation will be done by the intermediaries themselves⁽⁸³⁾. Moreover, it should also be noted that the argument relying on the excessive compliance and operative costs connected to the delta adjusted approach must be reconsidered in light of the application of the provisions of Regulation EU no. 648/2012 (so-called EMIR)⁽⁸⁴⁾. Indeed, as a result of the coming into force of the EMIR, certain obligations, in terms of both reporting to the trade repositories and valuation (*i.e.* daily valuation of the derivatives’ value on the basis of the mark-to-market) applicable to the financial counterparties and (upon certain conditions) to the non-financial counterparties already apply.

In conclusion, the amending Directive has certainly the merit to extend the disclosure obligations to all the instruments giving a long position on the reference shares in order to crack down on the hidden (morphable) ownership cases. That said, it should be noted that the situations which may potentially give rise to empty voting cases have been left aside. Indeed, the amending Directive does not provide for any reporting obligations of short positions in listed issuers.

⁸³ Without prejudice to any potential dispute surrounding the calculation performed by the intermediaries.

⁸⁴ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories. A thorough analysis of the EMIR falls outside of the scope of this article. In a nutshell, the Regulation introduces a complex regulatory framework applicable to OTC derivatives entered into by financial counterparties and/or non-financial counterparties. Such framework provides for certain central clearing obligations for derivatives with standard terms and conditions, other evaluation obligations, and certain margining and risk control measures. The text of the EMIR is available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:01:EN:HTML> accessed 15 November 2013.

2.3 Summary of the UK disclosure regime

It is common knowledge that the UK Disclosure and Transparency Rules (the DTRs) ⁽⁸⁵⁾ represent one of the most advanced and sophisticated legal frameworks existing in terms of disclosure obligations ⁽⁸⁶⁾. As a result, it has significantly influenced the European legislation as well as its proposed amendments.

As explained in further detail below, the UK rules reflect, to a large extent, the assumption that an all-embracing disclosure regime based on the economic position in addition to the voting rights may potentially solve the problems related to the use of cash-settled equity derivatives ⁽⁸⁷⁾.

By way of background, the DTRs have traditionally covered the holding of voting shares and qualifying financial instruments ⁽⁸⁸⁾ and, following a reform carried out in 2009, they now also extend to long cash-settled equity derivatives.

In this respect, starting from June 2009, the DTRs rules require that long equity swaps and other financial instruments with a similar economic effect to qualifying financial instruments ⁽⁸⁹⁾ be considered for threshold crossing purposes and for the consequent disclosure obligations.

⁸⁵ Under the FSA Handbook.

⁸⁶ The DTR are available at <http://fsahandbook.info/FSA/html/handbook/DTR>.

⁸⁷ See Paragraph 1.5.1 above.

⁸⁸ Under Chapter 5.3.2 (r) of the DTRs, qualifying financial instruments mean instruments that (i) result in an entitlement to acquire, on the holder's own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued of an issuer whose shares are admitted to trading on a regulated market or a UK prescribed market and (ii) give to the instrument holder, on maturity, either the unconditional right to acquire the underlying shares or the discretion as to his right to acquire such shares or not.

⁸⁹ Under Chapter 5.3.3 (g) 2 (a) of the DTRs, a financial instrument is deemed to have a similar economic effect to a qualifying financial instrument, if (i) its terms are referenced, in whole or in part, to an issuer's shares and (ii) generally, the holder of the financial instrument has, in effect, a long position on the economic performance of the shares, whether the instrument is settled for shares or for cash. By way of example, the following instruments may fall within the notion of financial instruments with similar economic effect: CfDs, swaps, options and forward sale transactions.

More precisely, for the purpose of threshold crossing, any long position held through equity swaps or other long cash-settled instruments, if referenced to shares of a UK issuer, must be aggregated with physical holdings of shares and qualifying financial instruments⁽⁹⁰⁾. The aggregate position must be disclosed if it reaches the 3 per cent. threshold and subsequently at 1 per cent. increments above that level.

Notably, the UK disclosure regime has adopted the delta-adjustment method. The reason for this policy choice is that disclosure of the entire nominal value of the underlying of an option (*i.e.* the nominal approach) would lead to disclosures of higher notional amounts. This would, in the view of FSA (now FCA), risk the market being misled. In fact, the advantage of a delta adjusted disclosure obligation is that it more accurately reflects the holders' real economic exposure to the underlying shares.

Similarly to the Transparency Directive, no netting between long and short positions is allowed.

It is also worth noting that in the UK, long positions in cash-settled equity derivatives also form part of the regulation on takeovers under the so-called Takeover Code⁽⁹¹⁾.

Briefly, the Takeover Panel amended the Takeover Code in 2005 to include economic positions when calculating the threshold for triggering the mandatory bid obligation as well as to require disclosure of CfDs positions of 1 per cent. or more in both the target and the

⁹⁰ Please note that the UK regulatory framework provides for a different disclosure regime depending on the nationality of the relevant issuer. A thorough analysis of this regime falls outside the scope of this article. For our purpose, the treatment of qualifying financial instruments and instruments with similar economic effects may be summarised as follows: (i) the disclosure obligation relating to instruments with similar economic effect only applies to UK incorporated issuers in relation to shares listed on a UK regulated market (*e.g.* London Stock Exchange) or on other European regulated markets, and on a UK prescribed market (*e.g.* Alternative Investment Market); and (ii) the disclosure of qualifying financial instruments applies to UK incorporated issuers in relation to shares listed on a UK regulated market or on other European regulated markets, and on a UK prescribed market as well as to non-UK incorporate issuers with Home State in the UK in relation to shares listed on a UK/European regulated market.

⁹¹ The Takeover Code – the analysis of which falls outside the scope of this article – is available at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf>.

bidder company during an offer period, thus securing a double relevance to long positions in cash-settled equity derivatives.

3. Practical impact of the extension of disclosure obligations to cash-settled derivatives

In order to clarify the treatment of cash-settled equity derivatives under the European and UK rules, it is worth analysing their application to a structure commonly used in the market for acquisition finance purposes. This structure is known in finance as cash-settled prepaid forward plus cash-settled equity swap. It results from the combination of (i) a cash-settled pre-paid forward and (ii) a cash-settled equity swap. The pre-paid forward falls within the category of the forward contracts which are OTC contracts entered into between two parties. These parties agree (i) in the event of a physical settlement, to buy or sell an asset at a specified future time at a price (forward price) agreed upon at the inception of the transaction or (ii) in the event of a cash settlement to pay the difference between the price at maturity and the forward price.

That said, in contrast to a standard forward, a prepaid forward provides for a cash flow exchange upon the entering into of the agreement and not only at maturity.

Indeed, the acquirer of the prepaid forward – which assumes a long position on the underlying shares, betting on an increase of the value of the underlying shares – is required to pay the prepayment amount (*i.e.* the forward price) at the inception of the transaction.

Conversely, an equity swap is a derivative where it is agreed that a set of future cash flows is to be exchanged between two counterparties at certain predetermined dates in the future. The two sets of cash flows are usually referred to as the legs of the swap. One of these legs is referred to as the floating leg and is usually pegged to a floating rate such as EURIBOR. This floating leg is usually “acquired” by the party assuming a short position on the underlying shares (*i.e.* the equity amount payer). The other leg – named the equity leg – is customarily based on the performance of a share and therefore attributes to the relevant holder a long position on such share (*i.e.* the equity amount receiver).

Under the proposed structure, a bank or another financial intermediary – providing an investment service – acquires the prepaid forward. Consequently, the institution pays the prepayment amount upon execution of the contract, thus holding a long position on the underlying shares. This prepayment amount will be used by the client to physically purchase the shares of the relevant issuer.

In light of the above, we can conclude that the prepayment amount corresponds *de facto* to the funds usually granted under a facility agreement by a bank to its client.

As it is the case with margin loans, under the above-described derivative structure, the purchased shares will be pledged in favour of the bank or the financial intermediary to secure the payment obligations of the client.

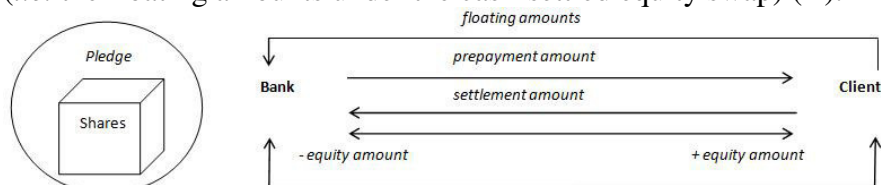
At maturity, under the prepaid forward, the bank will receive from the client an amount equal to the market value of the underlying shares on such date which may be higher or lower than the prepayment amount, thus recording a loss or a profit.

Under the equity swap, the client undertakes to periodically pay to the bank the floating amounts commonly calculated on the basis of the EURIBOR rate plus a spread. The duration of the equity swap is set equal to that of the prepaid forward and the initial price is equal to the prepayment amount.

The floating amounts constitute, *de facto*, the interests usually due under a facility agreement. In the event that, at the maturity date of the equity swap, the market price of the underlying shares is higher than the initial price, the bank will pay such upside to the client. In the opposite scenario, the client will be required to pay to the bank the value of the depreciation.

As shown by the chart below, as a result of the combination of the pre-paid forward and the equity swap, the client receives from the bank the funds to be used to acquire the reference shares. In turn, the financial institution offsets its exposure towards the performance of the shares underlying the derivatives, thus assuming a position similar to that arising under a typical facility agreement. Irrespective of the performance of the underlying shares, the bank will always be entitled to receive an amount equal to the funds granted to the clients (*i.e.* the

prepayment amount under the prepaid forward) with added interest (*i.e.* the floating amounts under the cash-settled equity swap) ⁽⁹²⁾.



Moving on to the disclosure treatment of the above described structure, the purchase of the shares issued by the target company will be subject to the disclosure obligation, both under the Transparency Directive, the amending Directive and the UK regime, provided that the relevant thresholds are crossed ⁽⁹³⁾.

⁹² In the event of an increase in the market price of the underlying shares, the bank would benefit from an upward trend, being entitled to receive from the client the value of the underlying shares at maturity. In order to better understand the functioning of the derivative structure the following example may be helpful. We assume that the prepayment amount under the prepaid forward, corresponding also to the initial price of the equity swap, is equal to EUR 10 for each share and that, at maturity, the value of the target's shares is equal to EUR 11. Under the forward, the bank will be entitled to receive the value of the underlying shares at maturity (*i.e.* EUR 11), thus realising a EUR 1 profit per share against the prepayment amount paid at the inception of the transaction (*i.e.* EUR 10). Conversely, the client will have the right to receive, from the bank, the upside of the underlying shares at maturity (*i.e.* EUR 1). As a result of the combination of the payoffs of the two derivatives, it results that the bank will always receive from the client an amount equal to the funds granted as a prepayment amount plus the interest to be paid as a floating amount under the equity swap. In the event of a decrease in the market price of the underlying shares to EUR 9, the bank will make a loss under the prepaid forward that will be offset by the obligation of the client to pay the absolute value of such decrease (*i.e.* EUR 1 per share) under the equity swap. It appears clear that, also in the event of a reduction in the performance of the underlying shares, as a result of the combination of the prepaid forward and the equity swap, the bank will be in the same position as it would have been in the event of an appreciation of the market value of such shares.

⁹³ Briefly, the relevant thresholds under Article 9 of the Transparency Directive are 5 per cent. and subsequent multiples of 5 up to 75 per cent. Pursuant to Rule 5.1.2 of the DTR, such thresholds are set at 3 per cent. and each 1 per cent. threshold up to 100 per cent. for UK issuers and at 5 per cent. and subsequent multiples of 5 up to 75 per cent. for non-UK issuers.

As per the pledge, it falls within the scope of the European and UK disclosure regime provided that the secured creditors – who will be required to disclose the shares pledged in its favour once the relevant thresholds are crossed – controls the voting rights attached to the pledged shares and declares its intention of exercising them ⁽⁹⁴⁾.

More complex is the treatment of the two long positions arising under the derivatives comprising the above described structure.

Starting from the European regulatory framework currently in force, synthetic economic long positions fall outside the scope of the reporting obligations. Therefore, the long positions held through the prepaid forward and the equity swap do not trigger any reporting obligations.

Conversely, under the amending Directive, such synthetic long positions are covered by the reporting obligations. More precisely, the economic positions will be firstly aggregated to the long potential holdings for the purpose of evaluating whether the reporting obligations have been triggered. Moreover, with a view to avoiding any possible circumvention of the disclosure regime by artificially splitting the overall long position on the underlying shares below the thresholds respectively set forth for (i) the holding of shares and (ii) the holding of long physically and cash-settled instruments, the amending Directive provides for a general aggregation criteria of all the long positions on the underlying shares possibly held by investors (whether through the holding of shares, long potential holdings or cash-settled long positions) ⁽⁹⁵⁾.

Similarly, under the UK rules, the long positions under the prepaid forward and the equity swap may, individually or together with the holding of shares or other qualifying financial instruments – give rise to a reporting obligation by, respectively, the bank or the client.

From the analysis above, it appears that, as a result of the concerns surrounding the potential abuse of cash-settled equity derivatives and in light of the well-known recent high profile cases, there is a clear tendency among European institutions and national regulators to

⁹⁴ See Article 10, 1st paragraph, letter (c) of the Transparency Directive and Rule 5.2.1, letter (c) of the DTR.

⁹⁵ See point 10 of the amending Directive.

tighten the legal framework applicable to economic synthetic long positions.

Consequently, long positions held through certain structures commonly used in the market for the purposes of acquisition financing – like the one previously described – may potentially be subject to reporting requirements by the bank or its counterparty (as the case may be).

The consideration above reflects a shared approach among European institutions and national regulators which favours an extension of the disclosure obligations to long synthetic positions irrespective of whether such instruments are held for legitimate financial reasons or for control-seeking purposes.

As a result, the attractiveness of certain common structures used in the corporate equity derivative industry may be adversely affected and alternative structures will have to be found by market participants.

4. Conclusions

As noted by eminent scholars, the holding of voting rights coupled with the economic ownership of shares has been a longstanding fundamental assumption of most of the law and economics theories⁽⁹⁶⁾.

With the advent of the revolution in finance such theories are no longer valid or, at least, need to be significantly recast.

Indeed, innovation in equity derivatives and the massive use of the stock lending practises may potentially allow investors (both insiders and outside investors) to easily decouple and split the voting rights from the economic ownership, often without giving a proper disclosure to the market.

In this respect, opponents of mandatory disclosure regimes often maintain that decoupling can increase and facilitate shareholders' oversight, foster efficient investment decisions and increase market's liquidity.

⁹⁶ See H.T.C. Hu and B. Black, *Hedge Funds, Insiders and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, (n 5) 23.

I do not find these arguments decisive. As a general remark, the opacity often surrounding positive or negative net economic positions built up through cash-settled equity derivatives can potentially impair the general capital market climate by creating information asymmetries and by reducing market liquidity. This, in turn, would result in an increased cost of capital for listed issuers and in the creation of inefficiencies.

Even more serious harm is likely to be produced where cash-settled equity derivatives are directly used for control-seeking purpose. Indeed, as described above, an issue with this scenario is that other uninformed investors may not be able to properly assess the real governance structure of the company they are investing in. Consequently, their decision making process may be altered and distorted *ex ante*, thus leading to a possible sub-optimal allocation of resources. In the specific context of takeover bids, it appears evident that the lack of available information surrounding the acquisition of hidden toeholds may allow the relevant bidder to artificially lower⁽⁹⁷⁾ the offered premium. This could have the potential effect of inducing investors⁽⁹⁸⁾ to tender their shares on the basis of a price which is sub-optimal, as it does not fully reflect all the information on the target company⁽⁹⁹⁾. Moreover, such a mechanism would deter other potential bidders from launching a counter-offer thus affecting the exit possibilities of the other target's shareholders.

In light of the above, I support the argument that a greater transparency regime regarding the holding of equity swaps and other cash-settled equity derivatives is required. This is needed in order to root out (or more likely reduce) the abusive uses of such instruments previously described⁽¹⁰⁰⁾.

Therefore, the European debate on the possible extension of the scope of the disclosure requirements currently set forth in the

⁹⁷ Indeed, it is likely that information about possible toeholds coupled with rumours on a derivative holder possibly working towards the launch of a takeover bid will result in an increase in the prices of the relevant shares. See, *ex multis*, M. Kettunen and W.G. Ringe(n 5) 15.

⁹⁸ Also pursuant to the so-called "pressure to tender" theory.

⁹⁹ See T. Baums and M. Sauter, (n 36) 460.

¹⁰⁰ See M.C. Schouten, 'The Case for Mandatory Ownership Disclosure' (2010), 15 Stanford Journal of Law, Business, and Finance 127, 128.

Transparency Directive is welcome and the amending Directive may potentially represent a first (even if partial) step in the right direction.

That said, I truly believe that such amending Directive represents only a partial response to the issues arising out of the decoupling phenomena. Indeed, for the reasons previously discussed, the proposed new framework only focuses on the holding of long physically or cash-settled positions but does not apply to short positions which may give rise to the empty voting cases. A partial regulatory response to such cases is to be found in the short selling regime and, in particular, in the recent European regulation on short sales and credit default swaps ⁽¹⁰¹⁾. Briefly ⁽¹⁰²⁾, such regulation introduces certain disclosure obligations applicable to the net short position which is defined as “*the position remaining after deducting any long position that a natural or legal person holds in relation to the issued share capital from any short position that natural or legal person holds in relation to that capital*” ⁽¹⁰³⁾. In light of the above, it must be concluded that the regulation may offer a response to the empty voting phenomena in the event of negative economic ownership (*i.e.* a net short position) but does not extend to the cases where the voting rights are exercised by a fully hedged shareholders with zero economic ownership, who may equally be in conflict with the interests of the relevant issuers.

As per the hidden (morphable) ownership, the scope of the new rules will have to be properly calibrated and carefully limited to the cases which may materially impact on markets' stability and efficiency. Indeed, it is inevitable that a widespread catch-all transparency regime is likely to result in significant implementation costs which, in turn, are likely to affect not only major financial institutions but also other market participants (*e.g.* corporate issuers, hedge funds, private equity funds, etc.). It is also likely that a regulation improperly calibrated may lead to confusing or excessive disclosure that would likely frustrate the policy goals behind the extension of transparency rules to cash-settled equity derivatives. This

¹⁰¹ European Parliament and Council Regulation No 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps [2012] OJ L 86/1.

¹⁰² A thorough analysis of the provisions of the European Regulation falls outside the scope of this article.

¹⁰³ See Article 3, 4th paragraph.

is because, according to a very well known principle of law and economics, “too much information means no information”. Indeed, in the absence of a specific calibration of the transparency requirements, an unlimited extension of the disclosure obligations to all the holders of cash-settled instruments may result in a duplication of the reporting activity relating to the same holding, potentially giving misleading information to the market.

In this respect, in order to avoid such negative consequences which would adversely affect the industry of corporate equity derivatives and its positive effects in terms of market liquidity and reduction in the cost of capital, a key role should be played by the exemptions from the disclosure obligations.

In particular, I believe that, through an efficient use of the so-called (i) market maker exemption, (ii) trading-book exemption and (iii) client serving exemption, the disclosure obligations may be limited to the cases which may pose risks in terms of information asymmetry as well as market stability and efficiency.

In my view, such exemptions should operate as a first measure against duplicative and confusing disclosure. Moreover, they are also responsive to the conclusion that the relevant financial institution has not been engaged in any activist transaction and employs policies that assure that the exercise of the voting rights is not carried out to exert any influence on listed issuers’ corporate governance. In this respect, the amending Directive appears to move in the right direction.

In light of the above, it is possible to conclude that too much information means no information, but calibrated information means added value.