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Hidden (morphable) ownership in the context of the Transparency Directive and Takeover Directive

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I. Introduction

Classical theory of the companies law assigns voting rights to shareholders in proportion to number of shares held by them. One share - one vote rule is more common in public companies in U.S. than in Europe. Nevertheless, most of the European public companies (especially in the UK and Germany) apply one share - one vote rule[1].

In the older publications on voting in companies it was stated that it is not possible to separate the voting right from equity interest[2]. However, in recent years, we have been observing development in financial derivative products and hedging techniques, which make it possible to separate (decouple) the economic risk of public companies' shares from the voting rights[3]. The possibility of decoupling is vastly supported by expansion in the derivates markets, especially in the OTC market (over the counter, privately negotiated) of equity derivates and growth in the stock lending market[4].

The decoupling techniques may often be used to build up a stake avoiding disclosure rules or even mandatory bid rule.

The purpose of this paper is to present a concrete, yet comprehensive, view of current European regulations concerning empty voting and hidden ownership. The first part of the paper is focused on defining hidden ownership and presentation of market examples, where such hidden ownership was used. In the second part I am analyzing current European Union regulations with brief reference to regulations in major European Countries. Finally, I am presenting my conclusions on regulation of hidden ownership at the European Union level.

In this paper, I assume the following situational context: public companies (listed in European stock exchanges) with one class of common shares (each share with one vote) and diversified and fragmented pool of shareholders with different preferences and expectations.

II. Definition of hidden (morphable) ownership

As mentioned above, the growth in privately negotiated equity derivatives and in the share lending market has made it easier and cheaper to decouple economic ownership from voting rights.

We can divide the decoupling of shares into two different patterns.

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[1] Application of the one-share vote principle in Europe, Association of British Insurers / Deminor, March 2005, p. 9

[2] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 410 (1983)

[3] E. De Nardis, M. Tonello, Know Your Shareholders: The Use of Cash - Settled Equity Derivatives to Hide Corporate Ownership Interests, July 2010, available at http://ssrn.com/abstract=1648526

[4] H. Hu, B. Black, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 2007, available at http://ssrn.com/abstract=874098

In the first pattern, an investor holds more votes than economic ownership because the votes have been "emptied" of economic value. In the legal doctrine, this pattern is called "empty voting"[5] In some cases, it is possible to have negative economic ownership which means that it is in investor's favor to vote in a way that reduces the company's share price. A good illustration of empty voting is the Perry - Mylan case of 2004[6]. The problems arising from empty voting are out of the scope of this paper and will not be further discussed.

In the second possible pattern, an investor retains economic ownership that exceeds his voting rights. In many instances, an investor has informal access to voting rights which can be exercised by acquiring voting rights from an intermediary (derivatives dealer) or by instructing the intermediary on how to vote. In a legal doctrine such a pattern is referred to as "hidden (morphable) ownership"[7].

III. Decoupling techniques

There are many ways of decoupling voting rights from economic interest to achieve the effect of hidden ownership.

One method is to use the share lending market. Under a standard lending agreement, a borrower has voting rights but no economic ownership, while the lender has economic ownership without voting rights[8].

However, the most common and widely discussed practice is to use cash-settled derivatives, especially options or equity swaps.

A derivative is a security which derives its value from the values of other, more basic, underlying variables, for example stocks[9]. We can divide derivatives into two groups: physically - settled and cash - settled[10]. In case of physically - settled derivatives, one party must deliver the underlying asset to the other party at an agreed moment in exchange for specified payment. In case of cash - settled derivatives, the underlying asset is never physically delivered. The parties make only cash payments which correspond with changes in a price of the underlying asset. Moreover, this type of derivatives does not require a contracting party to ever own the underlying asset.

We can mark out two types of options. A "call option" gives a holder the right to buy the underlying asset by certain date for a certain price. A "put option" gives a holder the right to

[5] J. Barry, J. Hatfield, S. Kominers, On Derivates Markets and Social Welfare: A Theory of Empty Voting and Hidden Ownership, 2012, p. 14, available at http://ssrn.com/abstract=2134458
[6] H. Hu, B. Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, Southern Californa Law Review 2006, vol. 79, p. 828-830
[7] J. Barry, J. Hatfield, S. Kominers, On Derivates..., p. 14-15
[8] H. Hu, B. Black, The New Vote Buying..., p. 816
[9] J. Hull, Options, Futures, and other Derivatives, Pearson 2009, p. 1
[10] J. Barry, J. Hatfield, S. Kominers, On Derivates..., p. 19

sell the underlying asset by certain date for a certain price. So called "American options" can be exercised at any time up to expiration date, as opposed to "European options" which can be exercised on the expiration date only. Buyers are referred to as having long positions and sellers are referred to as having short positions[11]

A swap is an agreement between two parties to exchange cash flows in the future[12]. In the cash-settled equity swap, two parties make an agreement that resembles the position of a long and a short investor in a particular stock. The long party receives from the short party an amount adequate to increase in the value of the shares in the relevant period plus any paid dividends, while the short party normally receives from the long party an amount equal to the drop in the value of shares in the relevant period plus interest accumulated on the notional amount (e.g. LIBOR)[13].

Why does the use of cash - settled derivatives often lead to hidden (morphable) ownership? In most of the countries, disclosure and mandatory bid thresholds are applied in case of accumulation of a certain amount of voting rights, not economic ownership. If a holder of the long position of a derivative has the right to physical delivery of underlying shares, it would certainly create the obligation to disclose the number of voting rights owned and, in some cases, to make mandatory bid, because a regulation normally refers to voting rights held under contractual agreement.

With the cash - settled derivatives (such as options or equity swaps) only economic ownership is transferred and the long party does not have to adhere to any disclosure rule. However the cash - settled type of derivatives does not put the long party at the risk of being unable to acquire the voting rights or at least have significant impact on how the voting rights are exercised. Such a statement stems from typical hedging practice in derivatives market. It is common that the short party in the derivatives transaction (the derivatives dealer) acquires the underlying shares as a hedge[14]. This hedging technique may be the only sound commercial choice, if the derivative involves a substantial number of shares of a single company[15]. When a dealer hedges a derivative with matched shares it is often expected that the dealer would unwind the derivative and sell the shares to the counterparty or vote the shares as instructed[16].

As it is stated in literature, undisclosed stake building by cash - settled derivatives may produce many negatives effects. It may have many distortive effects on market and corporate governance, such as increase of information asymmetry on capital markets leading to inefficient price formation, misrepresentation in the company's shareholder base, postponement or evasion of disclosure rule or mandatory bid rule[17].

[11] J. Hull, Options..., p. 6-8
[12] J. Hull, Options..., p. 147
[13] E. De Nardis, M. Tonello, Know..., p. 2
[14] H. Hu, B. Black, The New Vote Buying..., p. 837
[15] E. De Nardis, M. Tonello, Know..., p. 2
[16] The U.K. Panel on Takeovers & Mergers, Dealing in Derivatives and Options: Outline proposals realting to amendment proposed to be made to The Takeover Code and SARs, January 2005, § 3.3; H. Hu, B. Black, The New Vote Buying..., p. 837-838
[17] E. De Nardis, M. Tonello, Know..., p. 3

IV. Market examples of hidden ownership

Hidden ownership is a sophisticated way not to disclose retention of voting rights, which are *de facto* exercisable at the investor's discretion. There are many examples in the European markets of using hidden ownership to accrue discretely voting rights without going public.

1. The Schaeffler - Continental case[18]

Continental AG is one of the largest public companies in Germany, listed in the prestigious DAX 30 index. Continental produces brake systems, powertrain, chassis systems and components, instrumentation, vehicle electronics, tires and engineering elastomers. The Schaeffler group is one of the largest industrial companies in Germany, with its leading brands INA, Luk and FAG.

In July 2008, Schaeffler Group announced that it had built up a stake of almost 36 percent of Continetal's shares. The 36 percent stake held by Schaeffler consisted of: direct ownership of 2.97 percent of shares, physically settled swap of 4.95 percent and cash settled swap of approximately 28 percent of Continental's shares[19]. On 15 July 2008, Schaeffler announced to the Continental's management board that it would issue an offer for all of Continental's shares, which had been rejected on 16 July 2008[20]. On 21 August 2008 Continental reached an agreement with Schaeffler on the takeover bid[21].

In the cash-settled swap the sole counterparty of Schaeffler was an investment bank - Merill Lynch which entered into an offsetting agreement with other banks to hedge the transaction. Eight of the investment banks were said to each hold 2.999 percent of the shares, which at the time was under 3% disclosure threshold. The transaction was investigated by BaFIn, the German securities regulator but it didn't find any violations of disclosure rules[22].

2. The Fiat case[23]

The Agnelli family controls Fiat Group Spa through a complicated structure of private and public companies[24].

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[18] To more broad information about the case see D. Zetzsche, Continental AG vs. Schaeffler, Hidden Ownership and European Law - Matter of Law, or Enforcement?, 2008, available at http://ssrn.com/abstract=1170987
[19] D. Zetzsche, Continental AG..., p. 7-8
[20] D. Zetzsche, Continental AG..., p. 5
[21] http://www.continental-corporation.com/www/portal_com_en/themes/continental/archive/hidden/takeover_offer/pr_2008_08_21_ar_en.html
[22] D. Zetzsche, Continental AG..., p. 6 and 33
[23] To more extensive information about the case see Tom Kirchmaier et al. , Financial Tunnelling and the Mandatory Bid Rule, 2009, p.12-14 available at http://ssrn.com/paper=613945

In 2002, the Fiat Group suffered massive losses and consortium of banks provided the company with 3 billions euro convertible loan. Under the terms of the loan agreement, the banks would convert the debt to equity if Fiat Group did not repay the loan in cash, thereby decreasing Agnelli's holdings to 23 %. In this case, and according to Italy's mandatory bid rule applicable at that time, the family would not be able to increase its holding possession in Fiat to 30% without making a mandatory bid for outstanding shares.

On 26 April 2005, the Fiat Group informed that it would not repay the loan. The same day Exor Group (the Agnelli's subsidary) entered into cash - settled equity swap with Merrill Lynch for 7 % of Fiat's shares, and waited to unwind the swap until the date of scheduled conversion (i.e. 20 September 2005). On 15 September 2005, Exor amended the swap to include physical delivery rather than cash settlement. Surprisingly, delivery was scheduled for 20 September 2005 and Agnelli's averted making a mandatory bid to Fiat's shareholders. The Consob, Italian regulator, launched investigation, but eventually ruled that no breach of Italy's mandatory bid rule had taken place[25].

V. Regulations at the European Union level

Disclosure rules as well as mandatory bid rules are regulated at the European Union level in:

1) The Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization 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 (hereinafter also called Transparency Directive or TD);

2) The Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 of 21 April 2004 on Takeover bids (hereinafter called Takeover Directive).

The Directive, unlike the EU Regulation, is an European Union legislative act which is not immediately applicable in member states. The directive only requires from member states to achieve particular result without imposing the means of achieving that result. That is why directives need to be transposed into national law[26].

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[24] see diagram in Tom Kirchmaier et al. , Financial Tunnelling..., p. 12
[25] H. Hu, B. Black, The New Vote Buying..., p. 837
[26] M. Muszyński, Unia Europejska. Historia. Architektura. Prawo, 2011, p. 162

1. The Disclosure Rules

Pursuant to Article 9 of the TD, the home Member State shall ensure that, where a shareholder acquires or disposes of shares of an issuer whose shares are admitted to trading on a regulated market and to which voting rights are attached, such shareholder shall notify the issuer of the proportion of voting rights of the issuer held by the shareholder as a result of the acquisition or disposal where that proportion reaches, exceeds or falls below the thresholds of 5 %, 10 %, 15 %, 20 %, 25 %, 30 %, 50 % and 75 %. The voting rights shall be calculated on the basis of all the shares to which voting rights are attached even if the exercise thereof is suspended. Moreover, this information shall also be given in respect of all the shares which are in the same class and to which voting rights are attached.

The Transparency Directive does not forbid to adopt more rigorous rules (thresholds)[27].

The Transparency Directive also requires disclosure of indirect holdings in concrete circumstances. In the context of hidden ownership, it is worth to analyze Article 10 g) of TD, which requires notification in case of holding voting rights by a third party in its own name on behalf of its actual owner[28]. In the hidden ownership case the voting rights are held by derivatives dealer (e.g. investment bank) on behalf of an investor. As it is stated in the doctrine, a broad interpretation of the Article 10 g) of TD would lessen certainty among market participants as to which type of long position of derivatives should be treated as shares[29]. However, it is an accepted interpretation that contractual scheme leads to the short party holding shares on behalf long party if the long party **(1)** bears the economic risk of the underlying shares **(2)** is capable of influencing the exercise of voting rights[30]. The long party to the derivative's transaction is economically exposed, while the short party (the dealer) tries to transfer the entire risk from the underlying shares to the counterparty. They do so by hedging position and acquiring the shares. Sometimes, hedge funds take on unhedged counter positions and in that case economic risk of the stocks' price is shared and would not be fully transferred to the long party[31].

The influence on voting rights is more difficult to establish. Ordinary cash - settled derivatives, for example equity swaps, do not have (as it was mentioned above) influence on voting rights. Although Art. 10 g) of the TD requires only a hypothetical evidence in order to establish whether the long party can influence the voting rights, it is mostly the matter of overall judgment of the facts, which certainly involves some level of speculation[32].

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[27] See Article 3.1 of TD

[28] See Article 10 g) of TD

[29] D. Zetzsche, Continental AG..., p. 20

[30] D. Zetzsche, Continental AG..., p. 20 with literature cited there

[31] D. Zetzsche, Continental AG..., p. 22

[32] D. Zetzsche, Continental AG..., p. 24

D. Zetzsche argues that *"European securities laws, in particular Art. 10 g) of the Transparency Directive, provides for apt rules to counter hidden ownership schemes"*. In my opinion, it is not possible to create a general rule concerning cash - settled derivatives stemming from art. 10 g). Such a general rule as Article 10 g) of the TD[33] is widely exposed to different interpretations. There is a considerable risk that similar cases would be assesed differently even by the regulator of the same Member State, only on the fragile basis as Article 10 g) of the TD. That is why cash - settled derivatives should be regulated by a separate provision of law.

According to Article 13 of the TD, 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. However, the general consensus is that instruments creating an economic effect similar to holdings of shares or entitlements to acquire shares (i.e. the long economic exposure to the issuer resulting from cash - settled derivatives) generally fall outside the scope of the directive[34].

Some of the member states adopted more strict rules on disclosure regime, which include disclosure of the long position of cash - settled derivatives. In the U.K., under the Disclosure and Transparency Rule with amendment effective as of 1 June 2009, disclosure obligation may be triggered by holding of cash - settled derivatives[35]. Similar regulations came into force in Switzerland in 2007[36].

Considering the above a question arises if it is necessary and appropriate to regulate disclosure of cash - settled derivatives at the European Union level or leave it in discretion of the Member States. In 2010, the European Commission (Directorate General Internal Market and Services) conducted a public consultation on the modernization of the Transparency Directive[37], several questions of which concerned disclosure of cash - settled derivatives. As a result of this consultation, most of the respondents considered that the disclosure of holdings of cash - settled derivatives would be beneficial to the market with a view to avoid hidden ownership[38]. Disclosure of the cash - settled derivatives would solve many problems surrounding it, such as negative impact on determination of fair market price in the takeover bids or price formation in a particular securities. It would also improve general transparency of the market. Many respondents have highlighted the positive experience with the UK disclosure system[39].

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[33] and its implementation in the member state's law.
[34] E. De Nardis, M. Tonello, Know..., p. 5
[35] See paragraph 5.3.2. of U.K. the Disclosure and Transparency Rules, available at http://fshandbook.info/FS/html/handbook/DTR/5/3
[36] See the Article 20 of the Swiss Federal act on Stock Exchanges and Securities Trading
[37] Consultation document on the modernisation of the 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, 27 May 2010, available at http://ec.europa.eu/internal_market/securities/docs/transparency/directive/consultation_questions_en.pdf
[38] Summary of responses to the consultation by DG Internal Market and Services on the modernisation of the Transparency Directive (2004/109/EC), 17 December 2010,p. 20-29 available at http://ec.europa.eu/internal_market/securities/docs/transparency/transparency-consultation-summary_en.pdf
[39] Summary of responses...., p. 21

On the other hand, some respondents stated that majority of cash - settled derivatives contracts are entered into only for speculative or hedging purposes and it is not possible to distinguish such transactions from transactions, which are entered into in order to hide position in the underlying assets. Introducing such a disclosure regime would significantly increase the organizational and compliance costs for intermediaries[40].

Most of the respondents were against uniform EU regime for the disclosure of major holdings of voting rights in EU Regulation, but at the same time supported further harmonization in the Transparency Directive[41].

As a follow-up to the aforementioned consultation, in 2011 the European Commission prepared a proposal of amendment to the Transparency Directive[42]. In the proposal, the Article 13 of the TD is changed in such a way that notification is also required in case of financial instruments with economic effect similar to those referred to in point a)[43], whether they give right to a physical settlement or not. Additionally, paragraph 1b will be inserted which stated that for the purpose of paragraph 1 of the Article 13, transferable securities, and options, futures, swaps, forward rate agreements, contract for differences and any other contracts which may be settled physically or in cash, shall be considered to be financial instruments, provided that they satisfy the conditions set out in points a) and b) of paragraph 1.

As far as I am concerned, the amendment proposed by the EU Commission is a move in the right direction. Finally, a minimal standard of regulations will be established regarding cash - settled derivatives, because currently this aspect of the disclosures regime is better regulated in some of the member states (e.g. U.K.) and in some countries this matter is not regulated at all (e.g. Poland). Nevertheless, I share the opposition to total unification of the disclosure regime through the EU regulation. It is a common knowledge that there are big differences within the EU capital markets, regarding the size, market capitalization or level of fragmentation of ownership. In such circumstances, Member States should be able to adjust various models of regulation to their own market. The unified regime would also deprive Member States of freedom to innovate, experiment and react quickly to changes in the capital markets, as the EU legislature is much slower than national.

2. The Mandatory Bid Rule

Pursuant to Article 5. 1 of the Takeover Directive, where a natural or legal person, as a result of his/her own acquisition or the acquisition by persons acting in concert with him/her, holds securities of a company as referred to in Article 1(1) which, added to any existing holdings of those securities of his/hers and the holdings of those securities of persons acting in concert

[40] Summary of responses..., p. 21
[41] Summary of responses..., p. 28 - 29
[42] available at http://eur-lex.europa.eu
[43] The point a) is similar to current version of the Article 13.1 TD

with him/her, directly or indirectly give him/her a specified percentage of voting rights in that company, giving him/her control of that company, Member States shall ensure that such a person is required to make a bid as a means of protecting the minority shareholders of that company. Such a bid shall be addressed at the earliest opportunity to all the holders of those securities for all their holdings at the equitable price as defined in paragraph 4.

According to Article 5. 3. of the Takeover Directive, the percentage of voting rights which confers control for the purposes of paragraph 1 and the method of its calculation shall be determined by the rules of the Member State in which the company has its registered office.

In the majority of European Countries the threshold, which creates an obligation to make a mandatory bid, is leveled around 30 % of outstanding voting rights[44].

While the method of calculation is in discretion of Member States, in some of the European countries rules applied for disclosure purposes are also applied to the mandatory bid, while in other Member States there are separate rules to calculate voting rights for mandatory bid purposes.

Some of the Member States have already enacted regulations which make cash settled derivatives relevant for determining mandatory bid's threshold[45], while others do not impose such rules for mandatory bids.

The disclosure regime and mandatory bid rule are linked and cannot be treated separately. The disclosure regime is some sort of announcement of accumulation of voting rights in a company, which in some cases lead to the control threshold being exceeded. The disclosure obligations should lead to presentation of actual structure of shareholders and their actual voting power. The mandatory bid rule has been established for the same reason. When voting power exceeds the threshold set by law, it is required to make an offer to all minority shareholders. It would not be desirable to maintain two regimes of assessing shareholder voting power, especially when there is evidence of using hidden ownership to avoid mandatory bid rule[46]. Such practices may bring confusion into the market regarding actual voting power of particular shareholders. In my opinion, regulations concerning cash – settled derivatives should also be introduced into the Takeover Directive. Unfortunately, there is not any legislative initiative in this area and participant in European markets can only rely on national regulations, without any minimal protection at the European Union level.

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[44] Commission Staff Working Document. Report on the implementation of the Directive on Takeover Bids, 2007, available at http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf
[45] See Rulet 6,9, 11 of the U.K. Takeover Code; E. De Nardis, M. Tonello, Know..., p. 6

[46] See Fiat's case described in paragraph IV of this paper

VI. Conclusions

As presented in this paper, recent devolvement in derivatives market created a real threat to existing regulations regarding disclosure regimes and mandatory bid rule. So called hidden ownership has been repeatedly used to avoid triggering of disclosures obligation or even mandatory bid rule. The main European cases show that hidden ownership can be successfully used to silently build up a stake in public companies.

In my opinion, the current legislative action at the European Union level regarding disclosure of a cash – settled derivatives is a step in the right direction. It is not a desirable situation when some countries (like the U.K.) introduce regulations on cash – settled derivatives, which secure interest of other shareholders and increase transparency of the market, while others do not regulate this area at all. Enacting an amendment to the Transparency Directive will contribute to diminish disparity of capital markets in each of the European Union Countries.

Despite positive amendments to the Transparency Directive, there is a need to amend also the Takeover Directive. The mandatory bid rule is strictly connected with disclosure obligation, which in this context we can call "an early warning signal". Coherent regulations on both disclosure regimes and mandatory bid rule would contribute to transparency and better protection of minority shareholders' rights.

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