Director Notes
The European Series

Know Your Shareholders: The Use of Cash-Settled Equity Derivatives to Hide Corporate Ownership Interests

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Regulators across Europe are increasingly aware of the market and governance distortions that may result from situations of hidden ownership, where investors use cash-settled equity derivatives to eschew disclosure rules while stealthily building up stakes in public corporations. Until a more stringent investor transparency regime is adopted, board members and senior executives should closely monitor their shareholder base.

Although European public companies may practice a number of deviations from the one-share, one-vote paradigm so dear to their American counterparts, corporate governance in Europe rests on the fundamental tenet that shareholders' voting rights should be proportional to economic ownership in the business.[1] In recent years, however, financial derivative products and innovative hedging techniques have increasingly enabled investors to separate the economic risk of owning shares of a public company from the ability to vote those shares.

The decoupling phenomenon has been fueled by the trend of extraordinary expansion in the derivatives market. According to a Deutche Börse/Eurex study published in April 2008, derivative instruments have grown around 24 percent per year in the last decade into a sizeable and truly global market with about €457 trillion of notional amount outstanding.[2] In Europe, the notional amounts outstanding of over-the-counter equity-linked derivatives, which are the type discussed in this report, peaked at U.S. $6,134 billion in June 2008, at the height of the recent financial crisis.[3]

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This report provides an overview of the implications on corporate governance of certain uses of equity derivatives. It outlines actions that, in the performance of their fiduciary duties, directors of corporations listed in Europe should consider in order to address or prevent situations of undisclosed stake building by means of such derivatives. It also discusses the recent regulatory initiatives undertaken to restrain abuses of these financial instruments in Belgium, France, Germany, Italy, the Netherlands, and the United Kingdom.

Hidden Ownership through Cash-Settled Equity Swaps

Derivatives are an important class of financial instruments that has taken center stage in today's capital markets.[4] The reason for their increasing popularity is two-fold: they offer risk protection, and they allow innovative investment strategies. In particular, in a regulatory environment where disclosure requirements are triggered by voting rights rather than economic interest, derivatives can be used to conceal equity. This practice—generally known as "hidden ownership"—is being used by investors and strategic bidders for the purpose of discretely accumulating equity stakes in business corporations listed on European stock exchanges.

For example, an investor that intends to avoid disclosing to the market an ownership position in a public company may do so by acquiring from a derivatives dealer a long cash-settled swap covering the equity position. Depending on what the investor's ultimate intentions are, should it decide to exercise the voting rights resulting from the equity position, it may terminate the swap arrangement and purchase the underlying shares from the dealer. As just described, this hidden ownership scheme allows the undisclosed retention of *de facto* voting rights exercisable at the investor's discretion.

It is the settlement type—for cash rather than through physical delivery—that explains why the derivative instrument lends itself to the hidden ownership scheme.

Under a cash-settled equity swap, two parties enter into an agreement that seeks to replicate the positions of a long and a short investor in a particular stock. The long party receives from the short party an amount equal to the increase in the value of the shares in the relevant period plus any paid dividends, while the short party generally receives from the long party an amount equal to the decrease in the value of the shares in the relevant period plus the interest accrued on the notional amount. Since the swap is cash-settled and there is no required physical delivery of the underlying shares, any value differences at the end of the relevant period are settled in cash. Should the holder of the long position have a right to the physical delivery of the underlying shares, such right would presumably trigger the disclosure requirements that the hidden owner is trying to avoid. This is because the triggering thresholds most commonly used by shareholder disclosure regimes, in European countries as well as in the United States, consist in holdings of a certain amount of voting rights, the computation of which generally includes rights exercisable under a contractual arrangement.

In the example above, the cash-settled swap arrangement should not expose the long party to the risk of being unable eventually to formalize the acquisition of the underlying shares and their voting rights. That is because the long party can typically rely on certain commercial practices in derivatives dealing:

- The derivatives dealer (i.e., the short party in the derivatives transaction) often holds the underlying securities as a hedge against its short position. 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 dealer, as alternative hedging strategies are likely to be limited and more expensive.
- For the dealer, to refuse to sell the shares to the long investor upon its termination of the swap could mean compromising a profitable business relationship. In fact, as the Code Committee of the United Kingdom's Panel on Takeovers and Mergers said in a report on these commercial practices, it is "frequently the expectation" of a long swap equity holder that the derivatives dealer would "ensure" that the shares are available to be voted by its customer and/or sold to the customer upon termination or expiration of the contractual relationship.[5]

Market distortions Undisclosed stake building through cash-settled derivatives can create numerous potentially distortive effects. First, it may affect the efficient operations of the financial markets and:

- give rise to speculation and volatility, should the markets be unable to react promptly when the relevant transactions and/or stakes are eventually disclosed;
- distort the market for corporate control, as other potential purchasers may be at a disadvantage compared to long parties in cash-settled derivatives;
- allow postponement or evasion of obligations in connection with mandatory tender offer rules (e.g., if the short party exercises in the interest of the long party the voting rights connected to the shares it has purchased for hedging purposes);
- increase information asymmetry on capital markets and lead to inefficient price formation; and
- cause investor confidence to wane as a result of market opacity and excessive volatility.

Financial Derivatives in the Spotlight

Since the onset of the recent credit crisis, the financial derivatives industry has often been in the public spotlight. For example, investment banks have been criticized for entering into controversial transactions involving these instruments, including shorting securities related to the subprime mortgage industry in relation to which they were acting as underwriters.

In a highly debated recent case, the United States Securities and Exchange Commission (SEC) accused Goldman Sachs of fraud in connection with a synthetic collateralized debt obligation allegedly marketed to investors in 2007 without disclosure of the involvement of a large hedge fund. The hedge fund had allegedly participated in the selection of the reference portfolio and then had shorted its position through credit default swaps entered into with Goldman Sachs.

Corporate governance distortions Second, hidden ownership practices may produce negative effects on corporate governance mechanisms and:

- misrepresent the company's shareholder base, as investors' public filings would only tell half the story regarding who actually owns a material stake in the company;
- alter the voting process and possibly lead to corporate changes that may not represent the general interest of all shareholders;
- diminish shareholder power at the annual general meeting, if the short party of the undisclosed cash-settled derivative neglects to exercise the voting rights associated with the derivative's underlying shares. For example, if the long party in a cash-settled derivative stealthily holds 70 percent of the share capital and the short party – having purchased the relevant shares to hedge its position – does not exercise the voting rights associated with those shares, only 30 percent of the corporation's share capital will potentially participate and vote at the general meeting of shareholders;
- avoid the triggering thresholds of tender offer rules; and
- possibly lead to situations of conflicts of interest, since, *inter alia*, hidden ownership positions could also be taken by corporate fiduciaries or their affiliates.

Needless to say, these effects will be compounded by those of other decoupling schemes that may be pursued in connection with the hidden ownership, including the widely discussed "empty voting" practice, where investors borrow shares in advance of a shareholder meeting for the sole purpose of affecting the outcome of the vote at such a meeting.[6]

Recent Cases

The Continental case

In July 2008, the Schaeffler Group announced that it had built up a stake of almost 36 percent of Continental's share capital, without any regulatory disclosure. In particular:

- 2.97 percent of the share capital of Continental was held in shares, while the separate threshold triggering disclosure obligations was at three percent;
- 4.95 percent of the share capital of Continental was held through physically settled derivatives, while the separate threshold triggering disclosure obligations was at five percent; and
- 28 percent of the share capital of Continental was stealthily held through cash-settled derivatives, which did not trigger any disclosure obligations under German law.

The Fiat case

In 2005, the Fiat holding company was able to maintain its control of the group without triggering disclosure obligations and mandatory tender offer rules, by amending a cash-settled derivative with underlying Fiat shares to require physical settlement concurrently with the expiration of a convertible loan. Consob (the Italian capital markets authority) has sanctioned the parties involved for providing misleading information to the market in respect of the wider transaction. Criminal proceedings are ongoing.

The Volkswagen case

In October 2008, Porsche announced that it had built up a stake in Volkswagen amounting to 72 percent of the corporation's share capital, almost half of which had been acquired without triggering disclosure requirements. Indeed, in addition to an effective shareholding of 42 percent of Volkswagen's share capital, Porsche held about 30 percent of the share capital through cash-settled derivatives. Some of the parties involved are, however, currently under investigation in connection with violations of market abuse rules.

Disclosure of Derivative Positions under European Union and Member State Laws

Recently publicized cases of undisclosed stake building have sparked a debate about the best regulatory strategies for responding to the phenomenon, including:

- whether to introduce disclosure obligations specifically triggered by long positions in listed companies or to adopt stricter criteria in applying existing legal instruments such as disclosure obligations in respect of concerted action;
- whether to extend the disclosure regime to all cash-settled derivatives or limit it to derivatives contracts traded over the counter;
- in determining notification thresholds, whether to adopt a nominal approach (based on the number of underlying shares of the derivative instrument) or a delta-adjusted approach (based on the number of shares the short party to the derivative instrument needs to hold to hedge its risk exposure);
- in determining notification thresholds, whether to aggregate all holdings (including holdings of shares and entitlements to acquire shares), only some holdings, or none;
- whether to establish exemptions to disclosure obligations (e.g., the market-maker exemption); and
- whether holdings of cash-settled derivatives should be considered for the purpose of the application of tender offer rules (e.g., to determine thresholds triggering mandatory offers).

The Transparency Directive The essential backdrop for an analysis of disclosure regimes currently effective in major European jurisdictions is the Transparency Directive adopted by the European Parliament and Council in December 2004.[7]

The directive—which does not prevent single member States from adopting more rigorous rules[8]—aims at improving investor confidence and market efficiency[9] by means of a harmonized system of transparency applicable to all business corporations listed in European stock exchanges.[10] In this context, it also sets forth disclosure obligations for holdings of financial instruments granting the right to purchase shares of a listed issuer.[11]

Hidden Ownership and Market Abuse Rules

Some recent cases of hidden ownership have shown that economic interests held through cash-settled derivatives may be relevant in respect of market abuse rules, with particular regard to disclosure of price-sensitive information and misleading information (or other forms of market manipulation).

The so-called Market Abuse Directive[a] prohibits:

- any relevant person who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates;[b]
- illegitimate transactions or orders to trade which give, or are likely to give, false or misleading signals as to the supply of, demand for, or price of financial instruments;
- illegitimate transactions or orders to trade which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level;
- transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance; and
- dissemination of information through the media, including the internet, or by any other means, which gives, or is likely to give, false or misleading signals regarding financial instruments.

a Directive 2003/6/EC of the European Parliament and Council, January 28, 2003 (the "Market Abuse Directive.")

b Under Article 2.1 of the Market Abuse Directive, a relevant person is any person who possesses inside information: (a) by virtue of her membership of the administrative, management or supervisory bodies of the issuer; (b) by virtue of her holding in the capital of the issuer; or (c) by virtue of her having access to the information through the exercise of her employment, profession or duties; or (d) by virtue of her criminal activities. Furthermore, Article 4 of the Market Abuse Directive extends the rules cited in the text to any other person who possesses inside information while that person knows, or should have known, that it is inside information.

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.[12]

European directives provide the general framework and key principles for a new regulatory system, and are typically followed by a series of implementation measures. The Committee of European Securities Regulators (CESR), which is responsible for providing advice on the implementation measures of the Transparency Directive, recently recommended the extension of shareholding notification obligations to instruments of similar economic effect to holding shares as well as to entitlements to acquire shares.[13] According to CESR, the disclosure of derivative positions should take place irrespective of whether the relevant instruments are settled physically or in cash, based on the observation that "it is likely that an investor with a significant economic long interest will seek to influence the issuer."[14] CESR is currently reviewing comments received to its consultation paper.

Belgium Under Belgian law, holdings of cash-settled derivatives do not trigger disclosure requirements. As the law now stands, disclosure must only be made in respect of holdings of shares or entitlements to acquire shares in listed issuers or entitlements to exercise voting rights in respect of shares in listed issuers.[15]

There are no publicly disclosed initiatives or proposals of the Belgian legislator to intervene on such matters.

France In France, a transparency regime applies to interests held through cash-settled derivatives as of November 2009, even though the mere holding of these derivatives does not, in itself, trigger any disclosure obligations.[16] Specifically, shareholders that are already under an obligation to disclose holdings in listed companies[17] must also disclose the number of shares underlying "any agreement or financial instrument which is exclusively cash-settled and which, for that person, has an economic effect similar to that of owning said shares," as well as the number of voting rights attached to such shares.[18]

However, holdings of cash-settled derivatives are not considered for the computation of whether the threshold triggering mandatory tender offer rules has been crossed.[19]

Germany German regulation was amended in 2008 to require that, for the determination of notification thresholds, holdings of shares be aggregated to holdings of entitlements to acquire shares. Holdings of cash-settled derivatives do not currently trigger any disclosure obligations.

It should be noted, however, that, following recent examples of undisclosed stake building, the German market has become much more prudent and sensitive to undisclosed cash-settled derivatives. Furthermore, in May 2010, the Federal Ministry of Finance published a discussion draft of new rule proposals ("Act on strengthening investor protection and improving the functionality of capital markets"), with the intention of establishing disclosure requirements in respect of, among others, cash-settled derivatives.[20] Under the draft, disclosure obligations would be triggered by long economic positions equal to five percent or more of a listed company's share capital if the instrument allows the short counterparty to hedge its risk by purchasing shares of the relevant company, irrespective of whether such shares have actually been purchased. It is unlikely that the new legislation will come into effect before 2011.

Italy Under existing Italian law, the mere holdings of cash-settled derivatives do not trigger any disclosure obligations. Consob, the Italian capital markets authority, has broad powers to regulate cases in which derivatives are subject to reporting obligations, although to date it has chosen not to use such powers in respect of cash-settled derivatives.[21]

Consob recently published a position paper on cash-settled derivatives with a view to stimulating a debate among market operators.[22] In its position paper, Consob generally adopts a neutral stance, suggesting regulatory alternatives and at times indicating the strategy it believes to be most effective and efficient. Among other things, it has indicated its preliminary intention to extend the scope of disclosure obligations to all interests held in listed companies through cash-settled derivatives, envisaging, at the same time, exceptions and safe harbors. Consob has also indicated its preliminary intention to mirror most exemptions provided under the Transparency Directive. New proposed rules based on the comments received regarding the position paper may be published in late 2010.

The Netherlands Dutch law does not currently envisage disclosure obligations for holdings of cash-settled derivatives. However, in 2009 the Dutch Ministry of Finance solicited comments on a draft legislative proposal that would provide for a requirement to disclose a three percent or greater "economic interest" in a Dutch NV with voting securities admitted to trading on a regulated market.

The Ministry of Finance is currently considering these comments with a view to publishing an official legislative proposal later this year or in 2011. If the draft legislative proposal were to be adopted by the Dutch legislature, Dutch law would contain disclosure requirements in respect of "economic interests" similar to those currently in effect in France and in the United Kingdom.

The United Kingdom The United Kingdom amended its Disclosure and Transparency Rules effective from June 1, 2009.[23] Under the new rules, disclosure obligations may be triggered by holdings of financial instruments that grant, in effect, a long position on the economic performance of the underlying shares.

In particular, cash-settled derivatives are aggregated to other holdings—including shares and entitlements to acquire shares—to determine notification thresholds, and disclosure obligations are triggered if the percentage of voting rights reaches, exceeds, or falls below three percent (and each one percent threshold thereafter).[24]

Cash-settled derivatives are also relevant for determining tender offer thresholds.[25]

Furthermore, during the validity period of a tender offer, among other things, any person holding a long economic position of more than one percent of the share capital of a corporation must disclose any holdings (including of shares, entitlements to acquire shares, and long economic positions).[26]

A Look at the United States

The CSX Case and Beyond

"Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[a] The United States has traditionally been at the forefront of both disclosure regulation and the development of financial derivatives. Federal and state courts have recently been called upon to opine on certain uses of financial derivatives aimed at decoupling voting rights and economic ownership.

In 2008, a federal court case arose out of a proxy fight where two hedge funds – the Children's Investment Fund (TCI) and 3G Capital Partners – sought to take control of CSX, a publicly traded corporation. TCI and 3G owned about four percent of shares in CSX outright and held equity swap positions that gave them economic interests equivalent to as much as 12 percent of shares in CSX. CSX brought an action against TCI and 3G, alleging violations of the reporting requirements of Section 13(d) of the Exchange Act. The court engaged in a lengthy analysis that led it to assert that there were "substantial reasons for concluding that TCI is the beneficial owner of the CSX shares" under Rule 13d-3(a).[b]

However, the court eventually found that TCI and 3G had violated Section 13(d), and, in particular, Rule 13d-3(b) – not Rule 13d-3(a) – as TCI and 3G had formed a "group" earlier than reported.[c]

Delaware courts have also given increased attention to the phenomenon, as demonstrated by the detailed analysis of vote buying – including thorough reference to academic articles – in the recent Delaware Supreme Court opinion issued in *Crown Emak Partners v. Kurz* (April 21, 2010).

On May 20, 2010 the Senate passed a financial regulatory reform bill establishing mandatory clearing and trading requirements as well as real-time reporting of trades of financial derivatives. In the coming weeks, the bill is expected to be reconciled by the Conference Committee with a similar bill passed by the House of Representatives in December 2009.

The Securities and Exchange Commission also recently created a special Division on Risk, Strategy and Financial Innovation. The new division was created in September 2009 and combines the Office of Economic Analysis, the Office of Risk Assessment, and other functions, in order to provide the Commission with sophisticated analysis on risk and economic analysis, strategic research, and financial innovation.

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a Louis D. Brandeis, *Other People's Money and How The Bankers Use It,* 1914 (2003 reprint), p. 92.

b Under Exchange Act Rule 13d-3(a), a beneficial owner of a security includes "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: voting power which includes the power to vote, or to direct the voting of, such security; and/or, investment power which includes the power to dispose, or to direct the disposition of, such security."

c Under Exchange Act Rule 13d-3(b), "any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the [Exchange] Act shall be deemed for purposes of such sections to be the beneficial owner of such security."

Recommendations to Corporate Directors

Directors should be aware of the risks and possible distortions caused by the undisclosed use of cash-settled equity derivatives, especially until the European Union and its member states adequately address this emerging phenomenon in their harmonized shareholder transparency regulation.

In March 2010, The Conference Board issued a series of recommendations to assist members of the board of directors of corporations exposed to activist investment.[27] The recommendations were drafted in collaboration with and endorsed by an expert committee specifically instituted to analyze the phenomenon (see p. 10). The decoupling of ownership interests and voting rights was among the investment tactics examined by the group. This section reproduces and expands on those recommendations that may also prove useful to prevent or address situations of hidden ownership.

Monitor trading activities Directors should ensure that the company relies on a sound process to monitor securities holdings, including derivative instruments where the company's securities are the underlying instrument. At a minimum, the company should regularly review public filings by investors and available shareholder lists. However, the thoroughness of the monitoring process should be elevated based on market indicators of abnormal shareholder activity that may signal situations of hidden ownership, including a sudden change in the percentage of short interests. In these cases, the company should consider availing itself of reputable securities surveillance services. These are market information providers that specialize in gathering trade settlement data from custodian banks and cross-referencing them with proprietary databases of historical investor holdings so as to gain insight into possible trading strategies.

Obtain insights from large investors In the new legal and economic environment following the onset of the financial crisis and the implementation of the shareholder rights directive, engaging shareholders effectively on fundamental corporate issues has become paramount.[28]

Through investor dialogue, the company can learn early about potential shareholder concerns and critical changes in its ownership base, including information on group voting arrangements and other understandings among shareholders acting in concert. Cultivating proactive relations with the investment community can prove particularly helpful with larger institutions such as pension funds and mutual funds. If a shareholder is discretely engaged in stock accumulations through derivative instruments or other similar expedients, no one better than its peers is likely to know about it, especially if these peers also own securities of the company.

However, when engaging shareholders, directors should take certain precautions. In particular, they should ensure that:

- shareholder engagement remains within reasonable bounds and that the board of directors clearly maintains a lead role in corporate governance;
- no requests of any specific group of shareholders are favored over those of any other group, in absence of a valid and disclosed reason;
- all shareholders are fully informed of engagement-related activities and are allowed to participate in and propose relevant matters in connection with them; and
- communications with any interested investors (e.g., holders of a cash-settled derivatives position) should rigorously follow applicable rules and regulations.

Commission perception studies Furthermore, regular outreach to investors can help management recognize a perceived valuation gap between the stock price and the company's intrinsic value, which is often the impetus for the recourse to hidden-ownership accumulation strategies. If such a valuation gap exists, the board may consider commissioning a perception study as a way to gain better insight into the issues causing the discrepancy. Findings from the study can be used as the basis for crafting a communication plan to close the valuation gap and reduce exposure to the hidden ownership phenomenon.

Expect regular reporting from management The board should be provided with regular reports on important shareholder intelligence, such as abnormal shareholder activity or a material change in the ownership of the company. As appropriate, directors should meet with executives to discuss the implications of these changes and trends and recognize possible situations of hidden ownership or empty voting.

Compile profiles of investors and prospective strategic bidders The board should expect management to maintain profiles of any private pool of capital (including private equity groups and hedge funds) with material investments in the company's securities as well as of any prospective strategic acquirer in the marketplace. With respect to financial investors, this normally involves management seeking an understanding of the background and the specific investment strategies pursued by such entities, including their prior investment decisions and tactics, time horizon, and fund managers' compensation structure and performance targets. With respect to strategic investors, this involves learning about competitive strategies, ability to leverage, and growth models.

Notify enforcement agencies Directors must ensure that any material information on shareholdings is promptly and effectively communicated to the market and regulators, in accordance with applicable laws. In particular, enforcement agencies should be notified in situations where there is sufficient evidence that a shareholder or a group of shareholders are operating under an undisclosed understanding with a group of investors or other market participants or dealers and, most important, in any case where there appears to be a violation of applicable securities regulation.

Understand the intentions of hidden owners The company should not assume that investors resorting to hidden ownership schemes always pursue a hostile intent or a merely speculative agenda. Instead, directors should remain open-minded and review significant requests made by such shareholders in light of the company's current strategy, industry benchmarks, analyst reports, and the investor profile and track record. Directors should be prepared to critically analyze and discuss management's position regarding the hidden owners. Ultimately, the decision of whether to take action in response to a request or threat by hidden owners should be based on the long-term interest of all shareholders.

Looking Ahead

Despite the debate sparked by recently publicized cases of hidden ownership, most jurisdictions considered in this report have not yet adopted rules imposing disclosure obligations for long economic positions held through cash-settled equity derivatives.

While it is probable that, in the current political climate, most of those countries will reform their shareholder disclosure regulation, timing and modalities for the implementation of new transparency standards remain unclear. National regulators may indeed choose to defer to the European Union and wait for harmonized guidance as to the specific regulatory strategies to use.

Directors of European corporations should therefore be aware of possible risks and distortions resulting from certain uses of cash-settled equity derivatives. In this case, more than ever, prevention may be the best of all remedies. This report encourages board members proactively to monitor their shareholder base, remain informed of emerging investment strategies and, where there is sufficient evidence that an investor is operating under an undisclosed arrangement or in violation of securities laws, adopt appropriate defensive measures and notify enforcement agencies.

The Conference Board Expert Committee on Shareholder Activism

The Expert Committee on Shareholder Activism is composed of leading professionals who contributed a diverse array of expertise (legal, financial, proxy solicitation, investor communication, board assessment, and succession planning, among others) to The Conference Board activism project. The project is part of a broader initiative by The Conference Board to build new avenue for meaningful dialogue between companies and their shareholders.

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Endnotes

1 For a discussion of the most common forms of departure from the one-share, one-vote principle (including multiple class shares, golden shares, and pyramidal structures), see *Application of the one share-one vote principle in Europe*, Association of British Insurers/Deminor, March 2005. In October 2007, European Union Commissioner Charlie McCreevy announced that the European Commission would abandon its plan (which had been proposed two years earlier through the launch of a public consultation) to adopt a one-share, one-vote legislative reform; the plan had been fiercely opposed by countries such as France, Italy, and Sweden, where greater voting weight is often given to majority shareholders, government holdings, or long-time shareholders. See http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/592.

2 *The Global Derivatives Market. An Introduction*, Deutche Börse/Eurex White Paper, April 2008.

3 See the statistics provided by the Bank of International Settlements (BIS), available at www.bis.org/statistics/secstats.htm.

4 See Matteo Tonello and Stephan Rabimov, *The 2009 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition*, The Conference Board, Research Report No. 1455, 2009, for a discussion of the alternative instrument segment of the financial market.

5 See "Outline Proposals Relating to Amendments Proposed to be Made to The Takeover Code and the SARS," Consultation Paper, Panel on Takeovers and Mergers, January 7, 2005, available at www.thetakeoverpanel.org.uk. However, also see the *Brief of Amici Curiae International Swaps and Derivatives Association, Inc. and Securities Industry and Financial Markets Association*, in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al*. U.S. District Court, Southern District of New York, June 2, 2008, p. 10, available at www.isda.org, objecting to the premise that shares are available upon termination of the swap arrangement because swap dealers typically maintain a hedged position in such securities.

6 Henry T. C. Hu and Bernard Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership," *Southern California Law Review*, Vol. 79, No. 4, 2006, p. 811-908.

7 Directive 2004/109/EC of the European Parliament and Council, December 15, 2004 (the "Transparency Directive.") Pursuant to the Lamfalussy process used for the development of financial services regulation in the European Union, the European Commission then adopted a so-called Level 2 directive, Directive 2007/14/EC, on March 8, 2007. Finally, the Committee of European Securities Regulators (CESR) conducted Level 3 implementation procedures by publishing, on October 17, 2008, a "Summary of Responses to Questionnaire on Transposition of the Transparency Directive."

8 See Article 3.1 of the Transparency Directive.

9 See the Preambles to the Transparency Directive.

10 Under Article 9 of the Transparency Directive, each home member State shall ensure that, where a shareholder acquires or disposes of shares of a listed issuer and to which voting rights are attached, such shareholder notifies 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 five percent, 10 percent, 15 percent, 20 percent, 25 percent, 30 percent, 50 percent, and 75 percent.

11 In particular, under Article 13, disclosure obligations apply to any natural person or legal entity holding, directly or indirectly, financial instruments granting an entitlement to acquire, under a formal agreement binding under applicable law, on such holder's own initiative, a listed issuer's shares with voting rights. In its implementation measures, the European legislature specified that the holder of the financial instrument must enjoy, on maturity, either the unconditional right to acquire the underlying shares, or the discretion as to the right to acquire such shares or not.

12 See, for example, *Consultation Paper*, Committee of European Securities Regulators (CESR), January 2010, containing "CESR proposal to extend major shareholding notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares," available at www.cesr.eu. The paper clarifies (§13) that "[i]nstruments which do not give the right to acquire the voting rights are generally outside the scope of Article 13 of [the Transparency Directive]," although recognizing (§16) that if the long party is able to influence the exercise of the voting rights, the contractual scheme could "in certain cases be seen as a holding on behalf."

13 *Consultation Paper*, CESR, cited above. In November 2009, the European Securities Markets Expert Group (ESME) also published a memorandum entitled "Views on the Issue of Transparency of Holdings of Cash Settled Derivatives."

14 *Consultation Paper*, CESR, § 40-41.

15 See Law of May 2, 2007 *Loi relative à la publicité des participations importantes dans des émetteurs dont les actions sont admises à la négociation sur un marché réglementé et portant des dispositions")* and Royal Decree of February 14, 2008 (*"Arrêté royal relatif à la publicité des participations importantes"*).

16 On January 30, 2009, Ordonnance No. 2009-105 modified the French Commercial Code.

17 See Article L. 233-7 of the French Commercial Code. Under French law, notification obligations are triggered when holdings of shares or entitlements to acquire shares or voting rights reach, decrease below, or exceed five percent, 10 percent, 15 percent, 20 percent, 25 percent, 33 1/3 percent, 50 percent, 66 2/3 percent, 90 percent, or 95 percent of the outstanding shares or voting rights of a listed company.

18 See Article L. 233-7 of the French Commercial Code and Article 223-14 III 7° of the General Regulations of the Autorité des Marchés Financiers.

19 A bill (*"Projet de loi de régulation bancaire et financière"*) proposed by the French government on December 17, 2009 does not contemplate that cash-settled derivatives be taken into account for the computation of such threshold, although the bill is still at an early stage of the legislative process and is subject to change.

20 *"Gesetz zur Stärkung des Anlegerschutzes und Verbesserung der Funktionsfähigkeit des Kapitalmarkts,"* May 3, 2010.

21 Article 120.4.d-ter of the Italian Consolidated Law on Finance delegates to Consob the authority to determine in what cases holdings of financial derivatives trigger disclosure obligations.

22 "Consultation document on the disclosure of cash-settled derivatives," Consob, October 8, 2009, available at www.consob.it/mainen/legal_framework/consultations/index.html. Comments received are currently under review by Consob.

23 The rules are contained under paragraph 5 of the Disclosure and Transparency Rules, available at http://fsahandbook.info/FSA/html/handbook/DTR/5/1.

24 If the listed corporation is not incorporated in the United Kingdom, the thresholds are set at five percent, 10 percent, 15 percent, 20 percent, 25 percent, 30 percent, 50 percent, and 75 percent.

25 See Rules 6, 9 and 11 of the Takeover Code, available at www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/code.pdf.

26 Obligations under Rule 8 of the Takeover Code are triggered when an "offer period" is present for Takeover Code purposes. Indeed, once an "offer period" has commenced, the requirements of Rule 8 of the Takeover Code become relevant alongside the provisions under paragraph 5 of the Disclosure and Transparency Rules.

27 The recommendations are available in Matteo Tonello and Damien J. Park, *The Shareholder Activism Report*, The Conference Board, 2010, p. 13.

28 See Marco Scalera, "Investor Engagement in Europe in the Wake of the Shareholder Rights Directive Implementation," *Director Notes: The European Series*, No. 1, The Conference Board, April 2010.

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