Transparency requirements:

the issue of disclosure obligations applicable to economic exposure

EFLMG

Hubert de Vauplane

G.C Calyon, Crédit Agricole Group

CALYON
CRÉDIT AGRICOLE CIB

Shareholders's disclosure of major holding is limited to ownership :

Notification to market is triggered only upon <u>acquisition and disposal</u> of a financial instrument. The Transparency Directive (2004/109/EC) aimed to cover more complex situations (eg mandate, usufruct, temporary transfer) but notification obligation remained limited to disclosure of substantial physically-related equity positions

Extension of the regime to substantial « economic interests » in shares?

Transparency requirements : the issue of disclosure obligations applicable to economic exposures

Reason for such extension :

A number of recent cases in UK, Italy or Switzerland showed that derivatives cash-settled have been used to exert influence and/or build a substantial stake in a company on an undisclosed basis.

=> **Italy**. On Dec 5,2007, Consob has fined the two Merrill Lynch London based managers (Eur 150K and Eur 100K) for omission in shareholding notification in Fiat shares (April 2005) on behalf of IFIL due to Equity Swap agreement between Exor and Merrill (cash settlement in the beginning and then turned into physical settlement).

=> Switzerland. In March 2008, Swiss banking regulators are recommending criminal action against Laxey Partners, the $2bn London hedge fund, for breaching disclosure rules by using contracts for difference to build a big stake secretly in the country's biggest building services company, Implenia.

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=> **United Kingdom**: Recent studies showed that about 30% of equity trades are driven by contracts for difference (CFD) and that the view that funds holding large CFDs positions may influence management is widely held.

- **Some regulators raised the issue of the disclosure of substantial « economic interests »**

Due to these recent cases, some regulators decided to consider the issue of an additional disclosure obligation linked to economic interests position through (i) a public consultation (FSA in England, Takeovers Panel in Australia) and/or (ii) the implementation of the transparency directive (Italy).

1 - Summary of the issue.

In a nutshell, FSA establishes that « the key question is whether CfDs (which are equity swaps cash settled) are in effect a « substitute » for shares so that disclosure of CfD positions would bring the same benefits to price formation, takeover situations and market confidence as Major Shareholders Notification disclosures.

This would be the case where » :

⇒the underlying shares are actually physically delivered at maturity.

⇒ and/or CfD holders have influence on voting rights on shares held by CfD writers when hedging their positions.

2 - Options suggested by FSA.

– **Option 1 – Leave the current disclosure regime as it stands;**

– **Option 2 – Strengthen the current regime by requiring the disclosure of substantial economic interests unless the holder has taken « specific steps » to preclude himself from exercising influence over the underlying shares :**

« specific steps » relate to specific provisions to be inserted in the contract (safe harbour provision) whereby :

(i) the CfD holder is forbidden from exercing influence over related shares (held as a hedge in writer's portofolio)

(ii) the parties undertake not to agree on any arrangement in relation to the potential sale of the underlying shares

(iii) the holder declares that he does not have any intention to obtain access to shares or influence on voting rights.

– **Option 3 - Introduce a comprehensive regime, similar to the major shareholder notification regime, which would require disclosure by all holders of substantial economic interests in shares.**

- **3 - ISDA response (letters 12 February / 7 March 2008)**

“As discussed in our response [letter dated 12 Feb.], ISDA remains of the view that the case has not yet been made for changing the current disclosure regime, and we therefore strongly urge you to re-consider Option 1”.

Other regulators

Switzerland : Introduction of a new regime for the disclosure of major holdings in cash settled derivatives on 1 July 2007 and has recently consulted on a further expansion of its regime . In the previous regime, disclosure was mandatory in certain derivatives transactions only if the agreement provided or allowed for physical settlement. the new regime requires disclosure of a purchase or sale of rights convertible into shares (call options) and the writting of rights to sell shares (put options) irrespective of the way of settlement. Additionally, holdings in the underlying stock have to be added to holdings in derivatives when establishing whether thresholds have been crossed.

Takeovers Panel (Australia) - Discussion Paper equity derivatives (Sept.2007)

Panel's position goes beyond FSA policy. The central proposition of the Panel's paper is that long, cash-settled equity derivatives positions should be disclosed in the same circumstances as a physical holding of the underlying shares. These proposals would apply to all derivatives holdings, not just in takeover situations.

Italy – Implementation of Transparency Directive

Consob is working on a draft implementation of Transparency Directive. It should be ready and published for consultation within end of March 2008. It will include a Consob proposal to extend the transparency/notifications requirements also to equity swap cash-settled in case they potentially exceed the 5% threshold

TO GO FURTHER ON TRANSPARENCY.....
A European Recommandation on proportionality? (1/2)

Lack of proportionality due to control-enhanced mechanisms.

A recent international study showed that corporate "control-enhancing mechanisms" ("CEMs") are relatively common accross the EU. CEMs are legal techniques allowing for the "separation of ownership from control", which raises the proportionality issue. CEMs mostly used are pyramid structures, multiple voting rights and shareholders agreements.

Proportionality is usually described as follows : "proportionality between ultimate economic risk and control means that share capital which has an unlimited right to participate in the profits of the company or in the residue on liquidation, <u>and only such share capital</u>, should normally carry control rights, in proportion to risk carried" (*definition given by the High Level Group of Company Law Experts of 2002*).

Proportionality is commonly referred as to the "one share, one vote" problem.

A European Recommandation on proportionality? (2/2)

A European Recommandation?

In a Commission Staff Working Document (*Impact assessment on the Proportionality between Capital and Control in Listed Companies* - December 2007), the Commission

=> presents the pros and cons of possible policy actions

=> and analyses the possibility to issue a Recommandation in order to increase the transparency around non-proportional practices.

CONCLUSION

• Considering the fragmentation approaches followed in Europe, EFLMG should handle the issue of Contract for Differences in order to ask the Commission for a harmonized implementation on level 3 of Transparency Directive;

•EFLMG should consider what solution is the most convinient, taking into account (i) the need of transparency, for investors, issuers and regulators (ii) the need of flexibility for intermediairies.