European Commission Conference

Transparency obligations for listed companies: Scope for the modernization of the Transparency Directive?
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Modernization of the rules on disclosure of major holdings of voting rights

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Outline

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2. Cash-settled equity derivatives

3. Empty voting

N.B. Opinions expressed are exclusively the speaker’s and do not necessarily reflect those of Consob
1. Harmonization

- As always, to understand whether and how to harmonize, we should first understand why regulate at all
Why ownership disclosure? (i)
Ownership disclosure is functional to better corporate governance:

- Clear, updated picture of block-holders’ identity (including final beneficial owners):
  - allows to understand who has or may have an influence over management:
    - i.e., facilitates market monitoring of block-holders’ use and abuse of control power
  - allows investors to understand the degree of control contestability and the nature of controlling shareholders and blockholders more generally (e.g. having a private equity fund as controlling shareholder is not the same as having a family in the same position)
Why ownership disclosure? (ii)
Ownership disclosure is functional to better corporate governance:

BUT of course there are costs alongside benefits:

• Ownership disclosure raises the legal risk of institutions’ coordination for activism purposes (especially if “acting in concert” is defined too broadly or ambiguously);

• it reduces investors’ incentives to engage in activist strategies.
  – In fact, as ESME reports, many institutions choose to keep their holdings just below the threshold in order to avoid:
    • compliance costs of:
      – adaptation (cross-time and cross-country);
      – ongoing monitoring and filing;
    • liability/public enforcement risk (crucially depending on scope of disclosure).
Why ownership disclosure? (iii)

Ownership disclosure is functional to better corporate governance:

BUT of course there are costs alongside benefits:

• last and foremost, ownership disclosure works as an antitakeover device:
  • information on stake-building is an early warning for managers and incumbent blockholders;
  • ownership disclosure reduces potential bidders’ incentives (by forcing them to de facto declare their intentions early on, it makes acquisitions costlier).
Why ownership disclosure? (iv)
On the other hand, ownership disclosure is not directly functional to market efficiency

The idea that large long positions should be disclosed regardless of their impact on corporate governance, i.e. as large trading positions is misguided:

- investors’ incentives to incur in costs of searching information for active strategies are curbed if they cannot fully profit from their investment (which is the case if they have to disclose it);
- active investors may stop before the threshold so as not to disclose (with a reduction in market efficiency: again, ESME’s findings illustrate the point);
- manipulative use of mandatory ownership disclosure becomes possible (experienced in Italy): threshold is passed with the intention of pumping the stock.
Why ownership disclosure? (v)

Implications for policymaking in this area:

• Because there are costs as well as benefits, then a balanced approach is needed:
  – Too much (ownership) disclosure is no better than too little of it.
• Ownership disclosure's effect on the market for corporate control is negative
• Its impact on the market for corporate control makes it a politically highly sensitive topic.
  • Because Member States vary in terms of how hostile they are to hostile takeovers, leaving some scope for national policy solutions might be politically wise, if not inevitable (the story of the Takeover Bid Directive rings a bell)
What kind of harmonization? (i)

– Maximum harmonization in this area makes sense, in order to:
  • lower the costs of cross-border investment
  • equally importantly, curb Member States’ temptation to fix lower thresholds as an anti-takeover (i.e., protectionist) tool
What kind of harmonization? (ii)

But given these rationales, maximum harmonization needs not be comprehensive

1. Uniformity is key on technical aspects which are costly to adapt to:
   – Definition of holding, including treatment of stock lending (and of derivatives: see below), acting in concert, filing forms, timing, and means of dissemination, exemptions, etc.
   – In these areas, also CESR should do its part to achieve convergence in enforcement practices

2. Maximum harmonization on such issues can further capital markets integration by reducing transaction and compliance costs: standardization trumps substance

3. ... But there are also issues for which the rules' content is much more sensitive and relevant, while the need for uniformity is weaker due to lower adaptation costs
What kind of harmonization? (iii)

4. An issue that is both substantial and imposing low adaptation costs in case of divergence is the initial threshold:

- Here, because Member States differ as to how hostile to hostile takeovers they are, it may be wise to allow Member States to choose their own initial threshold within a range (from 3 to 10 percent) or among discreet figures such as 3, 5 and 10 percent, with the EU default at the current 5 percent level;

- To better preserve the functioning of the market for corporate control (as the EU should obviously aim to), a longer timing for disclosure to the issuer and the market could be fixed (e.g. 15 or even 30 days): this would not significantly hamper the corporate governance function of ownership disclosure
  - Perhaps an update as of the record date could also be required.
What kind of harmonization? (iv)

5. Declaration of intentions is another area where an optional, either-or harmonization approach could be justified

– In other words, Member States should be free to adopt either a regime requiring declaration of intentions (with content defined at EU level) or a regime without such a declaration

• Its antitakeover effect is self-evident, and it is therefore wiser to leave this delicate matter for Member States to decide.

• A declaration of intentions can be very costly in terms of liability/public enforcement risk, because it is extremely hard to tell whether one lies about intentions.
2. Cash-settled equity derivatives (i)

Why they matter

• If the ownership disclosure regime ignores cash-settled equity derivatives, it is under-inclusive (and easily avoidable, i.e. ineffective).

• If it includes them, it becomes over-inclusive (positions totally irrelevant for corporate governance purposes may have to be disclosed: costly compliance; information overflow. The lower the initial threshold, the more serious the problem).
Cash-settled equity derivatives (ii)

Two policy options can be conceived of:

1. A wider definition of the financial instruments/derivatives to be disclosed, including cash-settled ones (pure economic disclosure – CESR’s proposal: option 1);

2. Alternatively, no obligation to include cash-settled derivatives, but aggressive, substance-oriented enforcement approach of “acting in concert” and “holding on behalf” concepts (see US case law). Strong enforcement could be supported by an ancillary duty to report to regulators any long position (including cash-settled derivatives) exceeding the relevant thresholds (Zetzsche, 2010) (option 2).
Cash-settled equity derivatives (iii)

Should the EU choose between the two regimes and impose a one-size-fits-all solution?

• Given the high compliance costs this extension entails, an optional, either-or harmonized regime (with all the necessary technical details of both options defined at EU level in order to minimize the costs of different regimes for investors) could be considered.
3. Empty voting (i)

• A ban on empty voting would be no more justified than prohibiting deviations from one-share-one-vote, a solution the European Commission has already rejected.
  
  – The case of negative cash-flow rights (net short positions) should be dealt with like any instance of shareholders’ conflicted voting, an issue national company laws traditionally deal with.

• But short positions by those with a given voting power (i.e. over the initial threshold) are useful to know (also to help policing conflicted voting).
  
  – Because it is voting we're concerned with, there would be no need for continuous disclosure: disclosure of positions as of the record date would be enough.
Empty voting (ii)

• Should we worry about post-record date empty voting (due to risk of selling or shorting between record and meeting dates)?
  – Doubtful: shouldn’t we also worry of “practically empty” voting by shareholders planning to sell or short the shares the day after the meeting? Two days after? When do we stop?
  – Although shares are sometimes (borrowed and) traded around the record-date for voting purposes, empirical research shows that this form of vote trading is not linked to conflicted voting (Christoffersen et al. 2007).