



CONSOB POSITION PAPER ON THE DISCLOSURE OF CASH-SETTLED DERIVATIVES[°]

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Interested parties are welcome to submit their comments to the position paper, in English or Italian, and send their responses at the following address:

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Comments should reach us by 20 November 2009.

[°] This translation has been prepared for information purposes only. It is not intended to be nor does it constitute an official version of the text. For all legal purposes reference should be made to the Italian text.

POSITION PAPER
DISCLOSURE OF CASH-SETTLED DERIVATIVES

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1. INTRODUCTION - ORIGIN OF THE REGULATORY INITIATIVE

In recent times, we have witnessed the gradual spread of derivatives which enable the owner to hold economic interests in specific shares without the concurrent assignment or transfer of the right to buy or sell the underlying asset; and, therefore, without any provisions governing the contract in terms of physical delivery¹. However, the purchase or sale of these instruments does not always constitute merely a financial bet on the value of the asset. Indeed, in certain cases such derivatives, although originally established under cash settlement, may be used to generate non-transparent positions on a given security (hidden ownership). The party which issues a derivative (the “short” party, usually an investment bank) tends to hedge against the risk assumed by purchasing the underlying securities² on the market, and this allows the counterparties to opt for physical delivery of the securities once the contract has reached its expiry date. A number of cases that occurred on the markets over the last few years³ have confirmed the frequency and

¹ As it is well-known, the “long” position in such transactions is the one that benefits from the upward fluctuations of the underlying asset and is penalised when the underlying depreciates; vice versa, the “short” position draws financial benefit from the downward fluctuations of the underlying asset, but is penalised when the underlying appreciates. For example, in a plain vanilla total return swap (TRS, a contract which is normally governed by the terms and conditions set forth by the International Swaps and Derivatives Association, ISDA) having a share as its underlying asset, the “long” party (total return receiver or guarantor) will receive a sum from the “short” party (total return payer or beneficiary) equivalent to the dividends paid during the swap duration, as well as a sum corresponding to the appreciation, if any, in the market value of the underlying asset over the same period. Vice versa, the “short” party will receive a sum equal to the interest on the notional amount plus any reduction in the value of the underlying shares during the swap duration.

² Sometimes intermediaries hedge their risk exposure by undersigning other derivative contracts with an opposite sign, thus extending the “hedging chain”. Generally, however, there is always a party who hedges against risk by buying on the market and, therefore, also these cases may result in the described effects.

³ Reference can be made, for example, to the Schaeffler case. In 2008 it acquired a 36% stake in Continental, in a non-transparent manner. Schaeffler had acquired a 2.97% stake in Continental, 4.95% in options with “physical” payment and had the right to acquire 28% through a cash-settled equity swap. Hence, it was not subject to any disclosure obligations whatsoever until the time of conversion, and the market was left in the dark about the event until such time as Schaeffler launched a takeover bid for 100% of Continental and declared its ownership of the options and the equity swap. Similarly, in the U.S. case CSX vs. The Children’s Investment Fund’s Management (TCI), TCI suddenly announced that it owned 11% of CSX by means of a cash settled equity swap that it had carried out with five different investment banks, which was eventually concluded under physical delivery. As regards the Italian context, see for example the Ifil-Exor case, in which an investment of approximately 8% of Fiat’s share capital acquired by Merrill Lynch to hedge the position taken within an equity swap stipulated with Exor played a key

significance of this phenomenon.

The present regulation on major shareholdings disclosure defined in the Issuers' Regulations implementing art. 120 of the Italian Consolidated Law on Finance ("TUF") provides that in Italy, as in most of the other major countries⁴ and in accordance with the European directive on the subject (Transparency Directive or *breviter* TD), only derivatives which expressly provide for or permit the physical delivery of the underlying asset must be taken into account for the purpose of determining the obligation to disclose major shareholdings. Differently, the same obligations do not apply in the case of transactions on cash-settled derivatives with listed shares as their underlying asset.

The lack of transparency in transactions on cash-settled derivatives may prove to be critical in certain cases. Through the establishment of positions in cash-settled derivatives, in fact, it is possible to acquire a major stake in a company without disclosing such event to the market (so-called undisclosed stake building). Similarly, the short party may take an empty vote or the holder of the hidden stake may be able to exert influence over the voting procedure. In other words, the use of cash-settled derivatives allows for the decoupling⁵ of the financial interest (specifically, that of the long position) from the voting rights (exercised by the "short" party, which, however, has no interest in the related financial effects), thus upsetting the system of corporate governance which traditionally presupposes, at least for homogeneous categories of shares, proportionality between ownership and voting rights.

role in enabling the Agnelli Group to maintain its status as Fiat's main shareholder.

⁴ Few are the countries that enforce a law on major shareholdings disclosure which also takes into account cash-settled derivatives. Among these, Switzerland and Hong Kong are worthy of note. In Switzerland, the FINMA adopts an approach which is based on three separate groups of financial instruments: shares, long equity derivatives and short equity derivatives. Once one of the three groups' thresholds is crossed, all the stakes in all the three groups have to be disclosed, both in the case of physical and cash settlement. Differently, in Hong Kong all equity derivatives have to be summed up with shares. Finally, it is worth noting that in the UK all equity derivatives have long been accounted for in the takeover discipline, while they have only recently been considered for transparency purposes (see *infra*).

⁵ The most recent literature on the subject has, in turn, defined decoupling as a particular case of the more general group of transactions through which investors, and the issuing companies, can separate individual elements out of the whole of rights and duties generally associated with the ownership of capital or debt.

Under such circumstances, the firm's strategic choices of a shareholder might be influenced in a non-transparent manner, and this may directly undermine the interests of the other shareholders (for example, through transactions involving conflicts of interest). More generally, market efficiency would be undermined given that, when the ownership structure of an undertaking is non-transparent, the market misses out on significant information such as the type of shareholder and its intentions (especially its time horizon) and, as a result, is unable to correctly assess its value.

Considering the potential negative effects of insufficient transparency of such situations, the Supervisory Authorities of the major European countries have launched a number of projects with the aim of identifying possible options for revising the legislation on major shareholdings disclosure, and establishing a balance between the need to reduce the risk of circumvention connected with the use of cash-settled derivatives, on the one hand, and the need to avoid placing an excessive burden on operators who use such instruments strictly for speculative purposes, on the other.

Although the analysis of the European context appears to indicate a widespread willingness to extend the scope of major shareholdings disclosure duties to cash-settled derivatives, the technical methods for implementing this process have yet to be finalised. Diverging opinions have already been expressed on a number of important issues, such as the criteria to be adopted for calculating the underlying of the various types of derivatives (and, in particular, options), the aggregation between positions taken as "actual" stakes and those which are only potential stakes (and, in particular, between cash.-settled and physical-settled stakes), as well as the definition of the thresholds.

An issue which has still not been addressed by the guidelines issued in European countries, but which has already been tackled by the Italian legal system with reference to physical-settled derivatives, concerns the possibility of considering not only long positions but also short positions. Short positions actually give rise to the same need for transparency and, under given circumstances, may lead to critical situations such as, for example, what the financial and legal literature defines as empty voting.

Considering the importance of such aspects and the need to properly consider the costs that such regulatory intervention would entail, CONSOB deems it suitable to conduct a specific and separate market consultation procedure on the relevance of cash-settled derivatives to major shareholding disclosure duties.

This position paper aims therefore to consult the market on this subject by identifying the analytical elements needed for a proper assessment of the regulatory options available and analysing the main potential effects of these elements on shareholding structures and, in a broader sense, on corporate governance. To this end, the second section will illustrate the Italian legal framework, the third will explain the regulatory asymmetry between cash-settled and physical-settled transactions; the fourth will provide a brief analysis of the main guidance offered by the literature; the fifth will describe the regulatory framework of two major European countries; the sixth will analyse the main drivers of the possible regulatory options and, lastly, the seventh section will call for useful evidence on the new CONSOB's regulatory powers on takeovers.

Hence, this position paper does not aim to put forward a specific regulatory proposal given that, at this stage, we deemed it appropriate to maintain an open position which would allow, first of all, us to carry out an analysis of the key decision drivers underlying the possible extension of the scope of disclosure regulations to cash-settled derivatives. In fact, this is a complex phenomenon which has only recently assumed greater importance with respect to the typical objectives of the major shareholdings disclosure legislation. As such, a careful assessment of the regulatory intervention methods is necessary, also in the light of market evolution and of the indications provided not only by the international coordination bodies, but also by other EU countries.

Nevertheless, a number of specific "working hypotheses" have been identified on some of the possible basic choices, based on a preliminary assessment of the expected effects, with respect to which evaluations, comments and data are appreciated. Subsequently, an analysis of the costs and benefits of a closed circle of regulatory options will be conducted on the basis of the results and opinions gathered, with the aim of selecting a definitive solution in the first months of 2010.

So as to encourage a more methodical assessment of the answers provided, you are strongly recommended to reply to this consultation, in any event using the questionnaire, supplemented by additional information and evaluations considered useful.

2. LEGAL FRAMEWORK

As mentioned, the current Italian rules on shareholders' notifications take into consideration the detention of equity derivatives only if these instruments allow the holder to buy or sell, on their own initiative, the underlying shares (i.e. they are physically settled). This is because physical settled instruments are not only used for speculative and hedging reasons but they also allow the actual transfer of the underlying security. In particular, article 119 of the Issuers Regulation envisages, for the instruments above mentioned, a 2% initial threshold and does not allow for the aggregation of shares and physical-settled equity derivatives.

Hence, up to now, the holding of cash-settled long or short positions on listed shares has not been subject to an ad hoc disclosure requirement by virtue of the shareholders' notifications rules. In fact, the internal dealing regulation requires some cash-settled equity derivatives to be disclosed by relevant actors within the firm (e.g. shareholders with a stake bigger than 10%, managers, etc). However, this requirement is aimed at signalling to the market insiders' exposure, an objective which is clearly different from that of shareholders' disclosure.

Regarding the takeover regulation, the Consolidated Law on Finance traditionally does not account the holding of cash and physical-settled equity derivatives from the 30% threshold which imposes a mandatory bid. However, this issue has been recently addressed by the Legislative Decree approved by the Government on 18th September 2009 and containing "Integrations and amendments to the Legislative Decree of 19th November 2007 n° 229" (hereinafter "Amending Decree"), which has required CONSOB to determine the cases and the ways in which the holding of equity derivatives is to be considered as an actual stake for the takeover discipline purposes.

3. REGULATORY ASYMMETRY BETWEEN CASH-SETTLED AND PHYSICAL-SETTLED TRANSACTIONS

As mentioned in the introduction, the phenomenon of derivatives on listed shares (in particular swaps, options, forwards, contracts for difference) which provide for a cash settlement may assume importance from the viewpoint of the disclosure of issuers' shareholding structures.

Actually, it has been noted that derivatives on listed shares, although providing for a cash settlement procedure, may indirectly fulfil not only the typical functions described above, but also those of buying or selling the underlying shares in real terms and, in some cases, they are to be treated, as far as their effects are concerned, as positions which provide for physical settlement. A number of recent cash-settled OTC derivative transactions have in fact highlighted that, independently from the specific features of each single contractual structure, there is a sort of “equality” in economic terms between cash settlement and physical delivery of the underlying assets.

This “equality” of transaction settlement methods is stronger in the case where the party who intends to assume financial exposure over a given asset, has as its counterparty an intermediary who, through its own hedging strategy, assumes a neutral risk position within the contract (for example through the acquisition of a quantity of securities equivalent to the underlying of the derivative, and at a price equal to the value originally attributed to the latter). In such cases, if the intermediary is required to pay at the closing of the contract, the latter may, at the counterparty’s request, effect the payment through the physical delivery of the underlying assets instead of paying the difference in cash. In fact, as far as the intermediary is concerned, the market sale of the shares acquired for hedging purposes and the parallel payment to the counterparty of a percentage of the value corresponds, in financial terms, to selling all the shares to the counterparty.

For the purpose of clarifying this phenomenon, here is an example of an extremely simplified transaction which uses cash-settled derivatives. Assuming that party X has purchased a cash-settled derivative from bank Z, taking a long position in the shares of company Y for a shareholding equal to ALFA which exceeds the minimum threshold of disclosure, but which is not subject to disclosure duties, since the mere long position through cash-settled derivatives is irrelevant according to the current legislation on disclosure duties. Assuming moreover that bank Z has, in turn, put hedging strategies in place by purchasing the same amount of underlying assets. In this scenario, even without an explicit provision which permits X to request physical delivery from Z, and regardless of market fluctuations, X has in any case a good chance of coming into possession of the package accumulated by Z. In fact, after the expiration date Z will be forced to resell the assets on the market, exerting downward pressure on the share price.

Lacking an offeror to compete with X, the sale to X is the bank's most advantageous option. Even in the case where these market risks are contractually hedged, Z is in a situation where sale on the market and the disposal of securities to the counterparty is financially comparable.

In such cases, moreover, the intermediary, who is not interested in the financial performance of the underlying assets, may be induced to exercise voting rights on the shares acquired for hedging purposes in accordance with the instructions provided by the counterparty which has assumed financial exposure on the asset (i.e. empty voting).

In the same way, although in the opposite direction, cash-settled derivative transactions can be structured to allow the party which has taken the "short" position to transfer the ownership of a given quantity of shares at the closing of the contract as an alternative to paying the difference in cash, without any additional costs to be borne by the counterparty.

In both cases, where the counterparty in the derivative is a professional intermediary who offers a customised service specifically structured for the client, said counterparty may be willing, if required, to change the settlement terms agreed in the contract, provided this does not require the modification of the financial risks. Given that such contracts are negotiated over the counter and, hence, can be modified through the parties' mutual agreement, a change in settlement method may occur both by re-negotiating the contractual terms, through a shift from cash settlement to physical settlement, and by keeping the cash settlement and making a disposal, immediately after the closing of the contract, of the underlying asset.

More generally, it may occur that, even in the absence of any specific cooperation or willingness by the counterparty to amend the terms of settlement at the expiration date, where particular liquidity requirements for the shares constituting the object of the derivative contract are fulfilled, this latter may be used to perform a purchase/sale in real terms and at a preset share price, using the positive monetary differences deriving from cash settlement. In other words, it has been noted that, even if the cash settlement provision is not amended at the expiration date and transformed into a physical delivery provision, the contract underwriter will in any case be in a position of economic "strength", which will allow him to come more easily into possession of the underlying

assets.⁶

This essentially shows how the use of certain derivative structures under cash settlement actually grants a party the right to forward the purchase or sell, at a given price, a given quantity of securities resulting in effects which are similar to those of transactions granting the right to settle by physical delivery, and which are already subject to market disclosure duties. The result is a different type of disclosure duties for transactions which, on the contrary, are the same in terms of their financial effect. In the case of derivatives with settlement by physical delivery, in fact, the disclosure duties are effective as of the date of contract acceptance or of acquisition of the instrument. Differently, in the case of contracts or instruments under cash settlement, which are in any case used for acquiring or selling a listed share in real terms, the market disclosure of the acquisition or sale position may be postponed until the time the transaction is completed, thus losing the “anticipatory” aim of the obligation to disclose potential shareholdings.

4. MARKET FAILURES AND POLICY OBJECTIVES

As already mentioned in the introduction, the lack of transparency in cash-settled derivative transactions may determine, in certain cases, a serious hole in the legislation on major shareholdings disclosure. Such legislation attempts to solve a series of potential market failures of particular importance which may reduce the level of trust in the market and, ultimately, increase the cost of equity. In particular, the use of cash-settled derivatives for the purpose of determining changes in the ownership structure has two main downsides, both of which are connected to an information asymmetry issue.

- The first type of information asymmetry affects retail investors who are not informed on which positions in cash-settled derivatives have been negotiated on the OTC market, and especially, on who holds such positions and who may therefore exercise ownership rights over such assets. Such information, in the case where the derivative transactions are aimed not merely at hedging or financial betting purposes, but rather, at building a potential

⁶ The underwriter, in fact, may easily propose himself as counterparty to the intermediary who hedged its own market risk exposure by purchasing the underlying assets, regardless of whether such intermediary is the original counterparty of the swap or a third party.

shareholding, can be crucial for the investors' decisions and, consequently, can alter the market price discovery mechanism. The ability to accumulate non-transparent positions in cash-settled derivatives for this purpose makes it possible to catch the market by surprise, increasing the level of volatility and the possibility of speculation, to the detriment of the existing shareholders.

- A second type of information asymmetry concerns the effect that the lack of transparency on positions in cash-settled derivatives may have on the effectiveness of the market for corporate control and, more generally, on the corporate governance of the undertaking. The establishment of potential toehold positions, which remain hidden until they are transformed into shareholdings (which may occur instantly and also at a much later time than when they were established), prevents the market from reacting promptly to such changes. Furthermore, the lack of transparency on the various forms of decoupling of financial ownership from voting rights may accentuate the distorting effect on corporate governance, as the exercise of voting rights may become indifferent, if not negatively correlated, to the interest in maximising the company's value.

Nevertheless, it is important to note that a homogeneous set of indications on the importance of the aforesaid market failures is not provided by the financial and legal literature.

- As regards the first point, a number of studies reported in the literature⁷ have shown that, with the exception of certain insider trading phenomena, the lack of transparency in the ownership of pure financial interests alone, is unable to significantly affect the level of pricing efficiency. Conversely, others have argued that the level of uncertainty over the origin of certain transactions (whether or not they are connected with derivative position hedging phenomena) may increase market volatility, regardless of who holds the voting rights. At any rate, although a situation of information asymmetry with respect to the holders of voting rights may undermine market operations, the literature shows that a certain level of non-transparency constitutes a fundamental condition of the securities market and, in fact, may positively contribute to its liquidity and, ultimately, to its

⁷ See Jayaraman, Frye and Sabherwal (2001).

efficiency.⁸ It is therefore up to the Supervisory Authorities to assess the scope of such deficiency and the actual impact that it may have on prices under the given circumstances and, at the same time, to judge to what extent the regulatory intervention may improve the conditions of market efficiency.

- As regards the second point, the importance of the spread of financial derivatives for the purpose of correct functioning of corporate governance was recently underlined by a number of authors.⁹ As already analysed above, such phenomenon, known as decoupling, is in practice a new form of vote trading, which can in turn be broken down into empty voting and hidden ownership. Such cases may have an impact, and a distorting effect, on a system of corporate governance regulations which traditionally presupposes, at least for homogeneous categories of shares, a direct proportionality between financial ownership and voting rights.¹⁰ In particular, while a situation of (accentuated) empty voting may, in fact, compel the shareholder to vote in a manner which is not consistent with the company's interests, situations of hidden (morphable) financial ownership may conceal, in part or in whole, the identity of major shareholders. These latter, on the other hand, are able to quickly come into possession of the voting rights related to the secretly held shares, and to exercise the corresponding voting rights indirectly by exerting influence on the decisions of the intermediary counterparty in the transaction who has hedged against risk by acquiring the shares on the market.

Consider, for example, the case where a party acquires votes through securities lending, and uses the latter to block a buyout offer and, subsequently, benefits from the consequent crash of the shares through a non-disclosed short position.¹¹ Similarly, assume that a party holds a long position on a given asset, but lets the intermediary (holding the short position) exercise the voting rights on his behalf, thereby ensuring his anonymity to other investors

⁸ See the famous study by Grossman and Stiglitz (1980).

⁹ See Hu and Black (2007, 2008).

¹⁰ The literature on this matter is very extensive and well consolidated. After a few initial "pioneering" contributions such as that by Manne (1964), many authors (for example Grossman and Hart (1989) or De Angelo and De Angelo (1985) or more recently Burckart and Lee (2007)) have analysed the impact, in terms of efficiency of the market of corporate control, of deviations from the one share-one vote formula.

¹¹ Brav and Mathews (2009) reported for example the similar case of Henderson Land, a company headquartered in Hong Kong, which had an interest in acquiring a 25% stake in Henderson Investments.

until such time as he may deem convenient, for example to communicate the ownership of a major shareholding in the company. These are by all means “extreme” forms of empty voting and hidden ownership, but they can be clearly detrimental to the other shareholders.

The negative consequences of these strategies can be very serious, given that the incentive system on which the voting system is based may be substantially altered. Consequently, according to part of the doctrine, such strategies should be governed by specific legislation at least as far as increased transparency¹² is concerned.

Conversely, other authors¹³ take the view that these “vote trading” phenomena may increase the system’s efficiency, attributing voting rights to players who are able to come into possession of the best information and, hence, maximize the utility of their vote.¹⁴

A recent study¹⁵, which developed a theoretical model of analysis of the trade-off between a greater market efficiency due to the possibility of vote trading and the related cost in terms of non-transparency and information asymmetries which may affect market integrity, appears to support the thesis of increased market efficiency and, hence, of an increased value of voting rights. However, its results are not unequivocal.

In sum, the literature on the subject has provided an analysis of the impact of transactions using cash-settled derivatives on the efficiency and integrity of the stock market and of corporate governance systems. Nevertheless, a valid theoretical framework which makes it possible to assess the solutions at the regulatory level in an unequivocal manner is still to be provided.

Consequently, in the light of the growing importance of the phenomenon analysed herein and of the empirical evidence that rarely supports the “efficiency-oriented” thesis, the regulators of major countries are assessing the opportunity to make regulatory interventions aimed at increasing market transparency and consequently minimizing the risks that the new decoupling techniques may pose for investors.

Therefore, even though there are the preconditions for a regulatory intervention on cash-settled

¹² Hu and Black (2006, 2007).

¹³ Christoffersen, Geczy, Musto and Reed (2007).

¹⁴ See, for example, the case study presented by Hu and Black (2006, 2007).

¹⁵ Brav and Mathews (2008).

derivatives' disclosure, this should be traced to the actual critical issues that the insufficient level of transparency required by the present regulations is unable to solve. To this end, it will be necessary to develop a set of regulatory options and an analysis of the costs and benefits connected to each of them.

5. COMPARATIVE LEGAL ANALYSIS AND RECENT CASES

In the light of the numerous violations of the present regulatory framework, the Supervisory Authorities of the major European countries are considering the possibility of extending the number of transactions subject to disclosure duties, so as to include not only potential shareholdings settled through physical delivery, but also those which provide for a cash settlement.

a. United Kingdom

As regards the United Kingdom, domestic legislation has long provided for a form of reinforced transparency during the validity period of a Takeover Bid, by imposing the obligation to disclose any and all shareholdings (actual and potential, both physical and cash-settled¹⁶) exceeding 1%. The reasons for this are to be found in the fact that, during a public offering period, the share price is determined by the offering's chances of success, so that any interest in the shares (whether it be an actual purchase or a mere long position) constitutes a sign of confidence in the positive outcome of the offer.¹⁷

More recently, it was decided to redefine the broader legislation governing the disclosure of major shareholdings, whether or not a public offering procedure is already in place, with the aim of also including long positions in cash-settled derivatives¹⁸ as potential shareholdings. In order to

¹⁶ These are also included in the significant reporting threshold for public offering purposes.

¹⁷ Consistently, in order to reach the 30% threshold (relevant for the mandatory takeover), all interests in shares, and not only actual stakes, are taken into account.

¹⁸ Among these, the most common in the United Kingdom are the Contracts for Difference (CfDs) thanks to the fact that, in the UK tax system these are exempted from stamp duty. In a CfD, the "long" party bears the risk of stock depreciation for an interest fee on the notional amount. Vice versa, the "short" party bears the risk associated to asset appreciation and pays an amount equivalent to the distributed dividends. Technically, therefore, the two parties agree to exchange, at the closing of the contract, the difference between the opening and closing prices of an underlying financial asset. CfDs have a risk/reward ratio of 1 to 1, based on the difference between the purchase and sale price

define the methods for extending such disclosure obligation, in November 2007 the FSA (Financial Services Authority) published a Consultation Paper (CP 07/20). An initial, yet eventually rejected, hypothesis provided for an appropriate safe harbour which, if applied, would have allowed exemption from disclosure duties. Such safe harbour would have taken the form of an explicit agreement that would bind the parties to the non-transformation in any way whatsoever of the contract settlement methods (from cash to physical), therefore eliminating the possibility that a cash-settled derivative could be transformed into a potential shareholding. A second option concerned the actual extension of the scope of disclosure duties in terms of major shareholdings disclosure to cash-settled derivatives. The operational problems that the introduction of the safe harbour hypothesis would have caused induced the FSA to favour the second of the aforementioned hypotheses, as stated in the second CP (Consultation Paper 08/17), published in October 2008.

Over the course of the consultation process, numerous amendments were made to the original plan, which eventually assumed the following features:

- as regards the subject matter, the scope is extended from the original scope of contracts for differences (henceforth CfDs) up to and including also other financial instruments, which can be used for maintaining a financial interest in the issuers. Transparency legislation, however, applies to derivatives with specific methods, given that, while for CfDs the number of shares to be disclosed always corresponds to the number of shares underlying the contract (delta at 1¹⁹), for the other derivative contracts this measure varies according to the specific terms of the contract and to market context (known as delta adjustment);
- as regards aggregation, the initial approach which differentiated between the significant reporting thresholds in the case of shares (3%) and the rights to physical or cash purchase (5%), was replaced by a system which accumulates all the participating instruments maintaining the first transparency threshold at 3%. It is important to point out that the UK system does not recognise “short” positions in derivatives which, for this reason, cannot be offset via netting against long

of the underlying asset. In other words, CfDs are similar to other instruments such as spread betting or covered warrants, although they work in a distinct manner, as they implicitly allow to borrow money and, hence, to increase the exposure to an underlying asset.

¹⁹ From a hedging viewpoint, the delta of a derivative contract indicates the quantity of underlying asset that needs to be purchased or sold in order to compensate the losses or profits deriving from the fluctuations of the value of the same contract.

positions;

- finally, as regards exemptions, UK legislation not only implements the market maker and the trading book exemptions as set forth in the TD, but also introduces an additional exemption for intermediaries who act as counterparties in CfDs. By structuring transactions in derivatives on behalf of their own clients, these intermediaries inject liquidity into the market, although they do not play, unlike their clients, an important role in corporate control.

An additional “technical” consultation was recently completed (“Policy Statement 09/3” published on 3rd March 2009), the aim of which was to evaluate the opportunity to modify the procedures for implementing the aforementioned provisions. In the light of the results of such consultation, the FSA acknowledged the difficulties that the implementation of the delta adjustment mechanism for the purpose of disclosing cash-settled options could cause to certain operators. Consequently, whilst confirming that all positions connected to the holding of options must be disclosed by taking into account the delta adjustment, it was decided to grant a provisional period of seven months from the entry into force of the new provisions (on 1st June 2009), within which any disclosures on such instruments may also be carried out without applying such mechanism, provided that the market is provided with the necessary information to autonomously determine the underlying exposure.

b. France

On 23rd October 2008, the AMF (*Autorité des Marchés Financiers*) published a consultation paper on the disclosure of major shareholdings. The consultation was completed on 14th November 2008, and the French Authority received approximately 30 responses from the market participants.

The French paper took its cue from recent cases in which derivatives were used to take hidden positions in listed issuers, with the aim of establishing the principle whereby it is unlawful to conceal financial interests in capital. Hence, it is believed that any instruments which, on the holder’s initiative, make it possible to purchase already issued shares must be treated in the same way as owned shares.

In particular, as regards cash-settled derivatives, according to the paper, the market needs to gain access to the information on the holders of such rights and, therefore, states that they should be treated as potential shareholdings for transparency requirements purposes.

However, since the case of ownership of cash-settled derivatives had not been explicitly considered by primary legislation, an explicit intervention was required by the French government in order to settle the issue. On 30th January 2009, *Ordonnance* no. 2009-105 was issued through which AMF was entrusted with the promulgation of regulatory provisions aimed at establishing the conditions under which a cash-settled agreement or financial instrument must be considered as having the same financial effect as the direct holding of shares.

The new AMF regulation, which will be binding from 1st November 2009, introduces the following disclosure regime:

- a) a disclosure duty above relevant thresholds by aggregating shares and physical-settled equity derivatives;
- b) a separate disclosure, in case one of the above mentioned thresholds are crossed, of the underlying shares of any cash-settled equity derivative.

The French regulation thus imposes the aggregation of actual and potential physical-settled shareholdings, while it considers any position in cash-settled derivatives as an extra information which is disclosed to the market only when significant positions in shares or physical-settled derivatives have already been reached.

6. THE POLICY CHOICE IN ITALY: KEY ELEMENTS OF A POSSIBLE EXTENTION OF THE SCOPE OF DISCLOSURE DUTIES

As already highlighted in the final document of the Consultation on the Transparency Directive, considering the importance of the phenomenon under examination and the need to take proper account of the costs that such a regulatory intervention would entail, CONSOB deemed it appropriate to conduct a specific and separate market consultation procedure on the disclosure of cash-settled derivatives.

The analysis previously conducted clearly shows that not all transactions in stock market derivatives providing for a settlement through the differential payment at the expiration date are used by the contractual parties for the purpose of actually buying/selling a given share. Furthermore, given the complexity and the variety of market instruments and the various conditions of security settlement, identifying *ex ante* an unequivocal criterion for differentiating between transactions with “acquisitive” potential and hedging or purely speculative purpose

appears to be difficult.

The TUF, moreover, provides a broad mandate given that CONSOB has the right to establish “through regulation (...) the cases in which the holding of financial derivatives determines disclosure obligations” (refer to art. 120, par 4, *d-ter*).

a) The basic choice: providing a specific regulation on the transparency of cash derivatives?

The first issue that arises consists therefore in assessing, on the basis of a cost-benefit analysis, whether a change in the present legislation can be justified or if, on the other hand, the inevitable difficulty in identifying significant cases makes it more efficient to maintain the status quo.

In the first case, it would be necessary to extend the scope of the obligation to disclose major shareholdings beyond the current concept of actual shareholdings and potential shareholdings as set forth in the Issuers’ Regulations, so as to also include positions in cash-settled derivatives.

In the second case, while maintaining the current regulatory framework, a supervisory policy could be developed, aimed at identifying the most serious cases in which the use of cash-settled derivatives represents a form of violation of the obligation to disclose actual and/or potential shareholdings, i.e. when such transactions represent situations of interposed persons and/or acting in concert.

CONSOB working hypothesis: in the light of the cases which, also in the recent past, have raised the issue of transparency of cash-settled derivative positions, the concept of the use of interposed persons and of acting in concert do not appear to be fit for the purpose of implementing an effective enforcement activity. In fact, in addition to the inevitable probatory difficulties, such instruments would inevitably work *ex post*, mostly by initiating sanction proceedings against companies which violate the regulations in question. For that reason, the inhibitory effects of such enforcement mechanism lack the timeliness necessary to guarantee the on-going disclosure to the market²⁰ of thorough and accurate information, making this strategy potentially ineffective and, hence, sub-optimal to the amendment of the legislation.

²⁰ Furthermore, this instrument would be suitable for dealing with only one part of the phenomenon, and would work strictly in those cases where the structure of the derivative contract is used to conceal a different legal relationship (of interposition) between the parties.

As a result, the first question to be posed to the consulted parties is the following:

Q1) Do you consider it necessary to tackle the issue of cash-settled derivatives by providing for specific disclosure duties for such instruments or do you think that problems of circumventing behaviour inherent in the use of such instruments should be tackled strictly through the enforcement (or strengthening) of the existing regulations?

Q2) What are the major cost items that need to be verified in order to assess the regulatory intervention option?

b) Choosing a generalised or selective transparency regime

Should the regulatory intervention be deemed appropriate, it would then be necessary to define the most appropriate methods for extending disclosure duties to financial cash-settled derivatives. In particular, the objective of identifying transactions which are aimed at or provide for the physical delivery of the underlying asset, although originally carried out through a contract containing a cash-settlement provision, may be achieved by means of two separate regulatory strategies, one involving a “selective transparency” and the other a “generalised transparency”:

- The application of a selective transparency could be achieved by means of an explicit safe harbour by which any cash settlement contracts which the parties previously agreed not to amend (and hence would not involve the risk of changes in the shareholding structure) would be exempted from the disclosure duties. Disclosure duties would only be extended to contracts which, although containing a cash settlement provision, may be transformed (prior to or upon contract expiry) into physical delivery.
- Through the application of a generalised transparency, the disclosure duties would be extended to all contracts containing a cash settlement provision, regardless of the possibility of modifying such settlement method prior to contract expiry. This would make it possible to include also those transactions aimed at purchasing/selling the underlying value in real terms without, however, any amendment of the settlement provision contained in the contract.

The first option involves major difficulties because of the need to guarantee the necessary legal effectiveness in enforcing a no-renegotiation provision. Furthermore, this could leave room for circumvention transactions, which provide for the disposal of the asset underlying the contract

following its expiration date.

The second option has the drawback of including transactions strictly of a financial nature which do not produce any effect on shareholding structures. For the purpose of reducing the burdens imposed on the market, it is however possible to identify certain exceptions as a result of which the disclosure duty is lessened or eliminated. For example, various forms of exemption could be provided for to limit the burden imposed on operators who inject liquidity into the market (see *infra*).

CONSOB working hypothesis: following an initial examination and a number of legal analyses, we believe that the provision of a safe harbour in contracts which explicitly exclude the possibility of renegotiation of the terms of contract settlement poses serious enforcement problems. In particular, such provision appears to lose effectiveness in terms of substance, with respect to the unavoidable principle of the contractual autonomy of the contracting parties, which makes it possible at any time to redefine the relationships between the parties. Consequently, the benefits deriving from this regulatory option would be altogether minor. Vice versa, the enforcement costs would necessarily be much higher than the present ones, which would make the option under analysis less efficient in respect to the extension of the scope of disclosure duties to all the contracts containing a cash settlement provision. Hence, transparency provisions on cash-settled contracts should not be differentiated on the basis of whether or not the settlement provisions of the contract are binding. Any cost reduction for operators should then be pursued in a different manner (for example through an appropriate modulation of the obligations on the basis of other criteria such as aggregation and shareholdings calculation, or by means of specific exemptions – see *infra*).

Q3) Do you consider it appropriate to provide for disclosure duties for all contracts on listed shares which contain a cash settlement provision or do you deem it more adequate to provide for a safe harbour for contracts explicitly excluding the possibility of renegotiating the contractual terms of settlement?

Q4) If you deem it appropriate to include a safe harbour provision, how should a provision for the non-renegotiation of the settlement methods be structured in order for it to be effective?

Q4 bis) Do you find it useful that CONSOB envisages other safe harbours? Which ones?

c) The scope of disclosure duties

Another element worthy of consideration in order to best define the extension of the scope of disclosure duties to cash-settled derivatives concerns the decision of whether or not to extend the scope of the regulations only to contracts which are negotiated over the counter (OTC), or also to the standard contracts negotiated on the market. For the purpose of this decision, it will be necessary to observe whether positions in derivatives negotiated on markets are likely to result in coming into possession of the underlying security, and how this objective can be achieved. In fact, such positions are characterised by the presence of one single centralised counterparty, a circumstance which usually imposes serious limitations on the possibility of gaining direct access to the underlying.²¹

Conversely, it is important to underline that a regulatory provision addressing OTC derivatives only would inevitably establish the conditions for regulatory arbitrage phenomena. In fact, as it has been noted by several parties, cash-settled positions negotiated on the markets, which in any case confer a financial interest to their owner, may result in a position of improved access to the underlying asset at the expiration date, regardless of the related contract settlement provision. This idea is based on the hypothesis that immediately after the expiration date it is somewhat easier to buy the underlying on the market, a phenomenon the long party is generally conscious of²².

Also in this respect, it is important to consider that, if a disclosure obligation is imposed on all derivative transactions, that could result in the placing of an unjustified burden on certain operators who operate strictly for the purpose of financial speculation. However, such effect may in any case be limited by fine-tuning, on the one hand, the information thresholds and, on the other, the methods of aggregation between actual and potential shareholdings and the exemptions (see *infra*).

CONSOB working hypothesis: unlike the cases analysed in points a) and b), the present case does not seem to give rise to a clearly inefficient hypothesis. The options that will need to be analysed, therefore, will be determined by the results of further in-depth studies on quantitative and qualitative characteristics of the derivative market. To this end, the following questionnaire

²¹ Furthermore, the standardisation of such contracts simply rules out the possibility of amending the related settlement method.

²² Cf. FSA (2009:8-9).

was prepared which should be answered in the most detailed and structured manner.

Q5) Do you consider transactions for the purchase of cash-settled derivatives negotiated on the market suitable for pursuing the physical ownership/alienation of the underlying?

Q6) Do you think that other, intermediate solutions to those two set out above (i.e. the integration/non-integration of transactions on regulated markets) should be taken into consideration? If so, which options do you suggest?

Only for those operators which are active in these markets:

Q7) Can you provide an estimate of the volume of derivatives (CfDs, call options, put options, forward contracts...) that you negotiated in 2008, differentiating between market transactions and OTC transactions?

Q8) Can you provide an estimate of the average quantity that is negotiated in each single transaction with respect to both market transactions and OTC transactions?

d) Defining the criteria for calculating potential shareholdings involving the use of options

Another factor that needs to be considered in defining a possible system of cash-settled derivative transparency consists in the relationship between the notional value of the derivatives, that is, the number of securities constituting the theoretical underlying of the contract, and the quantity of underlying securities actually purchased or sold as hedging, and hence constituting the potential shareholding forming the object of the sale under the derivative contract. This ratio, which always equals 1 in the case of CfDs and of other equity derivatives having a symmetrical structure, is significantly lower for options, and is synthesised in the value of the delta ratio. In hedging strategies, in fact, the delta indicates the quantity of underlying shares that need to be purchased or sold in order to compensate the gains or losses generated by the movement in the option premium. By “delta weighting”, it is therefore possible to calculate the potential shareholding to which the owner of the derivatives may implicitly gain access.

The main difficulty resulting from the use of the delta adjustment consists in the fact that such value varies depending on the performance of the security underlying the option. Hence, the owner of the options needs to repeat the calculation of his own delta-adjusted position every time the value changes at the end of daily trading. However, in those cases where this type of mechanism has already been applied (for example in the United Kingdom with reference to the

short selling disclosure rule), no particular application difficulties or significant cost increases were reported.

CONSOB working hypothesis: also this point can hardly be properly assessed without first consulting market operators in order to understand whether and how such a provision could cause operational difficulties to the supervised parties. If an assessment of the effects should in any case prove difficult to carry out, it would however be possible to introduce a temporary, tentative solution, following the example of the United Kingdom, enabling operators to choose whether to report the delta-adjusted potential shareholding directly or, in the alternative, the nominal shareholding, including all the information required so as to allow the market to calculate the net exposure.

Q9) In the case of options, do you consider it appropriate to calculate the aforesaid thresholds on the basis of the shares constituting the underlying of the contract, or to weigh the percentage of optioned shares for the delta?

Q10) Do you think that the regulated parties would encounter any difficulties in implementing such provision? If so, what sort of difficulties?

Q11) Do you think that such provision could lead to significant costs? If so, please provide a monetary estimate of the impact.

Q12) Would you consider it appropriate to introduce a temporary experimental procedure which would make the aforesaid decision optional?

e) Defining the criteria for aggregating the various elements constituting a shareholding subject to disclosure duties

A further issue concerns the definition of the criteria for aggregating the various elements constituting a stake which is subject to disclosure duties. In the first analysis, we can hypothesize a separate disclosure of actual and of potential shareholdings (divided in turn according to the use of physical or cash settlement instruments). The immediate advantage of such a provision would be a simpler and more transparent system, but on the other hand, the lack of transparency would be even greater in the case of parties who decide to position themselves just below the disclosure threshold with all three possible positions. This is the case, for example, of a party which, after reporting that it exceeds the minimum disclosure threshold on all of the three elements (just over

2% for each item²³), accumulates other positions which eventually add up to 4.99% of actual shareholding, 4.99% of potential shareholding with physical delivery and 4.99% of potential shareholding with cash settlement. Such party would end up having an overall financial interest in the company of 14.97%, while reporting an interest of just over 6%. In the case of higher thresholds, the difference between interest held and interest reported would be even greater. Furthermore, separate disclosure may encourage the acquisition of financial interests through potential shareholdings to the detriment of actual shareholdings.

A possible solution to these problems lies in the aggregation of all the positions held, whether they be actual or potential, regardless of their respective settlement methods. As already mentioned above, such a strategy was adopted in the United Kingdom and considered in France. According to this approach, in consideration of the formal differences existing between a financial interest supported by an actual shareholding and one based on the ownership of a potential shareholding, in principle we could limit the aggregation to the two, physical or cash-settled, types which seem to characterise this second case. Moreover, based on the different approach which considers the actual (albeit potential) holding of shares a different phenomenon from mere financial interest, actual shareholdings could be aggregated with the potential physical-settled ones, thus separating them from the disclosures related to potential cash-settled shareholdings. As already mentioned, however, it has been pointed out by several authors that a common issue to all the choices providing for aggregated disclosures lies in an underestimation of the major difference, in terms of information effects, which distinguishes an actual shareholding from a potential one, and to a lesser but still significant extent, potential positions depending on whether they are cash-settled or physical-settled.

A balance between the need for information transparency and the need for making a distinction between different signalling effects resulting from the use of different instruments could be struck by devising a solution which maintains the current requirement of separate disclosure for both actual and potential physical-settled shareholdings, but introduces a further duty of disclosure for aggregate positive economic interests in shares (and independently from the clauses of each single derivative contract), when they exceed particularly significant reporting. This strategy would have

²³ The example implies thresholds for cash-settled derivatives which are similar to those currently established for physical-settled derivatives.

the advantage of retaining a clearer and simpler duty of separate disclosure, thus limiting reinforced disclosure duties for shareholders to cases of particular importance to supervision.

To summarize, three options can be taken into account:

1. total aggregation of the three items;
2. total disaggregation of the three items, providing for three separate disclosures: actual, potential physical-settled and potential cash-settled major shareholdings, respectively;
3. maintaining the current disclosure regime while introducing a new concept of total economic interest in shares, which would include all the potential and actual shareholdings and would be disclosed only above certain extremely relevant thresholds.

CONSOB working hypothesis: we currently have no evidence of any clearly inefficient hypothesis. In order to conduct a more thorough analysis of the issue, it will be necessary, on the one hand, to consider the characteristics of the current regulations which provide for a very low initial threshold (2%) and for a separate treatment of actual shareholdings and of potential physical-settled ones. On the other hand, it will be necessary to monitor the evolution of the regulatory framework at the international, and in particular, at the European level, which is currently still undefined, so as to properly assess the risk that investors may find it more convenient to invest in financial systems which feature a greater degree of transparency.

This, moreover, is an important policy choice which, due to the inevitable lack of a complete and reliable set of information, can hardly be solved strictly in the light of economic considerations. As an initial approximation, in the light of the objective of reducing the level of asymmetry with the present Italian regulatory framework and with the one being developed in some of the major European countries, priority could be given to the first working hypothesis (total aggregation of the three elements) and to the third one (maintaining the current regime while introducing a few relevant disclosure thresholds for the total interest in shares). The first hypothesis, which would be in line with the UK experience, is subject to potential costs in terms of information transparency: in fact, it somewhat shades the different signalling effects of the three elements of the reported major shareholding. Furthermore, some significant costs could arise also for the operators who would have to monitor their transactions in shares jointly with those in derivatives so not to exceed the threshold. This cost would still be there in the third hypothesis. However, since this latter does not impose a separate disclosure of cash-settled equity derivatives, it would not alter much the current system thus producing lower one-off compliance costs. As regards the total disaggregation hypothesis, an assessment of the costs in terms of possible circumventing

behaviours is required.

Q13) Which of the aforementioned options do you consider most effective? Why?

Q14) Do you think that other options should be considered?

f) Defining disclosure thresholds

Another variable that needs to be considered in order to define the information perimeter is the threshold beyond which such disclosures are actually mandatory. The first possibility seems to be that of retaining the already existing thresholds for actual and potential shareholdings. However, it is important to bear in mind that the entry threshold, at 2%, is significantly lower than that set out in the TD and in the internal regulations applicable in major European countries. In order to assess whether such threshold is adequate, it seems necessary to consider, on the one hand, the choices of the European partners and, on the other, the overall consistency of the disclosure system. For the latter purpose, the choice presented above appears to have particular importance.

Specifically:

- if options 1 is chosen, the threshold would necessarily have to be set at 2%, as provided for by the TUF;
- if, on the other hand, option 2 is chosen, the 2% minimum threshold (art. 120 of the TUF) would be binding for actual shareholdings while 5% (art. 9 of the Transparency) would constitute a maximum limit for potential physical-settled stakes. Thresholds for potential cash-settled shareholding could instead be freely determined;
- if, lastly, options 3 is chosen, the current threshold for actual and potential physical-settled shareholdings would still hold while the choice of relevant thresholds for the total economic interest in shares would be open.

CONSOB working hypothesis: the choice under examination is strictly correlated with that set out in point e). With reference to the priority hypotheses described above, in case of full aggregation, the threshold would be bounded at 2% by the current legislative framework (i.e. art. 120 TUF). Differently, in the case of option 3, some key aggregate thresholds for the total interest in shares could be freely determined while maintaining the current thresholds for both actual and potential physical-settled shareholdings.

Q15) Based on the answers set out in the previous point, which thresholds do you consider most

appropriate?

Q16) In particular, should option 3 be chosen, which aggregate thresholds would you propose?

g) Defining the cases of exemption

The last important factor in defining the scope of major shareholdings disclosure duties is the legislation on exemptions.

Consistently with the provisions contained in the Transparency Directive, an initial method suitable for limiting the disclosure obligations to those phenomena which may actually increase the level of transparency of ownership structures consists in extending the market maker exemption to cash-settled derivatives²⁴ for underwriters who act strictly as intermediaries and inject liquidity into the market, and the trading book exemption for those assets included in the trading book which are not considered to be strategic, whose thresholds are specified in the directive as 10% and 5% respectively.

As in the case of the United Kingdom, there is another method which could prove effective in preventing the possible duplication of disclosures that would result from the enforcement of an obligation on all the parties that exercise financial power or are in possession of the instruments in question. This would be to exempt from disclosure obligation all those intermediaries which are in possession of a long position (hedging a symmetric short position with respect to a customer) which is identical, in terms of quantity, timing and prices of reference, to that of the original counterparty.

Lastly, it should be considered whether those positions that are acquired indirectly through baskets of assets should be exempted from disclosure obligations. In order to prevent the use of such instruments for the purposes of circumventing regulations, account should be taken of the level of diversification of the baskets and of the percentage held in said baskets. If the net positions thus obtained is a shareholding which is below a given significant reporting threshold, no disclosure would then be required.

CONSOB working hypothesis: this aspect also appears to be strictly correlated with what will be decided with respect to points e) and f). Such provisions will determine the amount of benefits (in terms of reduced costs of compliance) that the introduction of the aforementioned exemptions

²⁴ Together with physical-settled ones, which are currently not included.

could provide to operators. Moreover, it will be possible to assess whether the information thus excluded may hinder the delivery of significant information to the market, which would otherwise be not accessible from disclosure duties imposed on other parties. Hence, CONSOB's position on the issue is open.

Q17) Do you agree with the adoption of the cases of exemption envisaged by the TD?

Q18) Do you consider it appropriate to exempt parties which have implemented a transaction with the aforementioned characteristics? If so, please illustrate your reasons.

Q19) Do you agree with the possibility of exempting shareholdings, under given conditions, which are acquired indirectly through baskets of shares? If so, what conditions would be appropriate?

Q20) Do you find it necessary that CONSOB envisages other exemptions? If yes, which ones?

7. EQUITY DERIVATIVES AND TAKEOVER REGULATION: CALL FOR EVIDENCE AND PRELIMINARY EVALUATIONS FOR THE IMPLEMENTATION OF CONSOB NEW REGULATORY POWERS

Finally, on the basis of what recently envisaged by the "Amending Decree" (see *supra*) which delegates CONSOB to point out the cases in which the holding of equity derivatives is to be considered as an actual shareholding and thus prompts a mandatory bid, CONSOB calls consulted parties to provide appropriate evidence and other useful information which might contribute to CONSOB's future work on this topic.

In particular, respondents are asked to provide CONSOB with their views on the possible specific features of the mandatory takeover bid discipline in respect to shareholder transparency, also with reference to:

- the types of equity derivatives to be included in the notion of shareholding;
- the way shareholdings are to be calculated when:
 - delta is lower than 1;
 - short and long positions are conjunctly held and have the same underlying asset;
 - equity derivatives are held through one or more baskets;
- whether market traded derivatives should be considered for the purposes of mandatory takeover.

The feedback provided on this last issue will be considered together with the answers to the

previous questionnaire so to draft one or more consultation documents on the way equity derivatives need to be considered for the purposes of both shareholders' transparency and mandatory takeover disciplines.

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