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Equity Derivatives and Transparency: When Should Substance Prevail?*

Guido Ferrarini

Klaus Hopt was the first European scholar to develop a systematic study of capital markets law from an international perspective. His works have been deeply influential on the formation of today's scholarship in securities regulation, after years of US dominance. As we all know, *Klaus* has always had a remarkable instinct for identifying new topics, often anticipating their future impact by several years. It is, therefore, quite natural to pay tribute to him by analyzing a relatively new issue of capital markets law, which recently emerged also in Europe, particularly in Germany and Italy, a country to which our great friend and outstanding colleague has dedicated, at different times, a non-negligible part of his very active and international life.

I. Introduction

In this paper, I consider the problem of 'hidden ownership' from a regulatory perspective,[1] asking whether and to what extent transparency rules require (or should require) disclosure of informal voting power in the case of

* Preliminary versions of this paper were presented at the CRELE inaugural conference 'Securities Litigation and Corporate Governance Cases' (Free University of Bozen, November 2007); at the first conference of the Italian Association of Business Law Professors 'Orizzonti del Diritto Commerciale' (University of Rome III, January 2009) and at workshops at Consob and Ghent University in April 2009. The author is grateful to *Marcello Bianchi, Hans De Wulf, Paolo Giudici, Henry Hu, Mario Libertini, Paul Mahoney, Giuliana Scognamiglio,* and other conference and workshop participants for very useful comments. Sec. 6 of this paper incorporates comments made with *Paolo Giudici* in a joint answer to Consob's position paper of October 2009 on the transparency of cash-settled equity derivatives. The author is grateful to *Filippo Chiodini* and *Paolo Saguato* for excellent research assistance.

[1] The concept of 'hidden ownership' was developed, with reference to the use of equity derivatives and other financial techniques, by *Henry Hu* and *Bernard Black* The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 S. Cal. L. Rev. 811 (2006); *Henry Hu* and *Bernard Black* Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011 (2006); *Henry Hu* and *Bernard Black* Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 13 J. Corp. Fin. 343 (2007); more

equity derivatives.[2] By equity derivatives I refer to both equity swaps and cash-settled options.[3] As shown by *Henry Hu* and *Bernard Black*, the derivatives revolution in finance – especially the growth of equity derivatives – is making it easier and cheaper to decouple economic ownership from voting power.[4] As a result, investors or insiders can have economic ownership that exceeds their 'formal' voting rights.[5] However, they may also have 'informal' access to voting rights by either acquiring the same from an intermediary (usually a derivatives trader) or instructing the intermediary on how to vote the company's shares.[6] To the extent that large shareholder disclosure rules do not clearly require disclosure of this 'informal' voting power, the concept of 'hidden (morphable) ownership' is used to indicate the 'combination of undisclosed economic ownership plus probable informal voting power'.[7]

recently, *Henry Hu* and *Bernard Black* Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. Pa. L. Rev. 625 (2008); and *Henry Hu* and *Bernard Black*, Debt Equity and Hybrid: Governance and Systemic Risk Implications, 14 Europ. Finan. Manage. 663 (2008).

2 The same problem was recently considered by *Dirk Zetzsche* Continental AG vs. Schaeffler, Hidden Ownership and European Law – Matter of Law or Enforcement?, CBC-RPS No. 0039, (October 29, 2008), available at SSRN: http://ssrn.com/abstract=1170987; *Dirk Zetzsche* Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental, 10 EBOR 115 (2009); and *Michael Schouten* The Case for Mandatory Ownership Disclosure (September 28, 2009), Stanford Journal of Law, Business & Finance, forthcoming; available at SSRN: http://ssrn.com/abstract=1327114. A similar question can be considered with respect to takeover law, asking whether and under what conditions the attribution of informal voting power to the long party of an equity derivative should trigger the obligation to launch a mandatory bid: for a brief treatment of this question, which was also raised by the case of Exor/IFIL/FIAT analyzed at sec. 5 below, see *Guido Ferrarini* Prestito titoli e derivati azionari nel governo societario, in Paola Balzarini, Giuseppe Carcano & Marco Ventoruzzo (eds.) La società per azioni oggi: tradizione, attualità e prospettive (2007), II, 629.

3 In the words of a banker: 'Equity swaps (and other equity derivatives) provide synthetic exposure to physical equities. In an equity swap, the return on a notional underlying share is exchanged for a return based on a reference interest rate or fixed yield'. See the case of Ithaca (Custodians) Ltd. V. *Perry Corp.*, [2003] 2 N.Z.L.R. 216 (H.C.), 46 (the case is discussed below at sec. 2).

4 See *Hu* and *Black* The New Vote Buying, supra note 1, 823. The authors define 'economic ownership' (at 824) as 'the economic returns associated with shares' and specify that it 'can be achieved directly by holding shares, or indirectly by holding a "coupled asset" that conveys returns that relate directly to those on the shares'. In the authors' terminology, coupled assets include derivatives, such as options, futures and equity swaps, and other financial products (Id.).

5 Id. defining (at 824) 'formal voting rights' as the legal right to vote shares, including the legal power to instruct someone else how to vote. Sometimes, investors (such as hedge funds) and insiders hold more votes than shares, a pattern that the authors call 'empty voting' 'because the votes have been emptied of an accompanying economic stake' (at 825).

6 Id. defining (at 824) 'voting rights' as 'either formal or informal rights to vote shares, including the de facto power to instruct someone else how to vote'.

7 Id. at 816.

The problem of hidden ownership was discussed in Germany with reference to the case of *Schaeffler/Continental.* In anticipation of its takeover of *Continental*, *Schaeffler* secured a stake of about 36 % of *Conti*'s share capital without making any disclosure to the market. On the one hand, *Schaeffler* purchased shares for 2.97 % of the target's capital and options for another 4.95 % without notifying its purchases. Indeed, German law only required disclosure of either direct ownership of more than 3 % of the shares of a publicly listed company[8] or *physically settled* derivatives on shares exceeding 5 % of capital.[9] On the other hand, *Schaeffler* entered into a *cash settled* total return swap with *Merrill Lynch* for a notional amount corresponding to 28 % of *Conti*'s capital. *Merrill Lynch* hedged its position under the swap by executing (cash settled) swap transactions with several other dealers, each for an amount of *Conti* shares below the minimum threshold for mandatory disclosure.[10] As a result, neither *Merrill*, nor the other intermediaries disclosed their interests in *Conti*; also *Schaeffler* kept its overall position (amounting to nearly 36 % of *Conti*'s equity) secret, while avoiding a mandatory takeover bid. Once *Schaeffler*'s position became public, *Continental* adopted a defensive strategy based on the claim that the whole scheme was illegal[11]. BaFin, however, concluded that no infringement of German securities and takeover law had been proven, since no agreement was found between the swap parties for either the transfer of the hedge shares or the exercise of voting rights.[12] This decision was intensely debated by German legal scholars,[13] who appeared

8 Article 22.1 of the WpHG.

9 Article 25.1 of the WpHG. The relevant positions were counted separately for disclosure purposes. The law was changed in 2008: see article 1.3 b) Gesetz zur Begrenzung der mit Finanzinvestitionen verbunden Risiken (Risikobegrenzungsgesetz) (12 August 2008) OJ 2008, 1666 (18 August 2008) requiring that the amount of directly (article 21 of WpHG) and indirectly (article 22 of WpHG) owned shares and other financial instruments (article 25 WpHG) be counted jointly for the purposes of disclosure (article 25 of WpHG as amended by article 1.3 b) of Risikobegrenzungsgesetz). See *Holger Fleischer* and *Klaus U. Schmolcke* Kapitalmarktrechtliche Beteiligungstransparenz und "Hidden Ownership" 29 ZIP 33 (2009) 1506, noting that the Risikobegrenzungsgesetz addressed the practice of gaining undisclosed influence on companies by acquisition of different positions, which were counted separately.

10 *Mathias Habersack* Beteiligungstransparenz adieu?, 53 AG Podium 22 (2008) 817; *Dirk Zetzsche* Hidden Ownership in Europe: *BAFin*'s Decision in *Schaeffler* v. *Continental*, supra note 2, 121 ff.

11 See *Dirk Zetzsche* Hidden Ownership in Europe: BAFin's Decision in Schaeffler v. Continental, supra note 2, 125 ff.

12 See BaFin, Press release of 21 August 2008, "BaFin: No breach of reporting requirements identified in Continental AG takeover procedure", available at: http://www.bafin.de/cln_116/nn_720494/SharedDocs/Mitteilungen/EN/2008/pm_080821_conti.html?_nnn=true.

13 For an overview of the discussion and the different opinions, see *Holger Fleischer* and *Klaus U. Schmolcke* supra note 9, 1504; *Theodor Baums* und *Maike Sauter* Anschleichen an Uebernahmeziele mit Hilfe von Aktienderivate, ZHR 173 (2009) 464 ff.

divided between those claiming that disclosure rules are applicable to cash settled derivative contracts (like swaps and options)[14] and those objecting to a similar reading of German law.[15] This scholarly discussion extended to the policy goals of possible legal reforms.[16]

In this paper, I consider the same problems from an international perspective, focusing on three well-known cases – two decided in common law jurisdictions and one in Italy – and drawing, from the comparative analysis of these cases, suggestions for the European policy debate. Section 2 analyzes the New Zealand case of *Ithaca* v. *Perry* (*Rubicon*), decided in 2003/2004 by the Auckland High Court and the Wellington Court of Appeal. Section 3 examines the case of *CSX Corporation* et al. v. *The Children's Investment Fund* et al., decided in 2008 by the United States District Court – Southern District of New York. Section 4 compares the two cases, showing differences

[14] The main argument being that transparency rules aim at ensuring effective and timely disclosure of economic interests and voting power for important shareholdings. The same rules protect investors and market efficiency at the same time. To the extent that derivative transactions would otherwise allow disclosure requirements to be avoided, the relevant rules should apply. See *Mathias Habersack* Beteiligungstransparenz adieu?, supra note 10, 818 ff., arguing that cash settled equity swaps should be included within the scope of art. 22.1 no. 2 of WpHG as shares held by a third party at disposal of the person who has the duty to disclose ("die einem Dritten gehören und von ihm für Rechnung des Meldepflichtigen gehalten werden"). For a similar opinion, see *Uwe H. Schneider* and *Tobias Brouwer* Kapitalmarktrechtliche Meldepflichten bei Finanzinstrumenten, 53 AG 16 (2008) 563 ff., claiming that an implicit (gentlemen's) agreement for the delivery of the shares referenced by a cash settled derivative contract should suffice for the application of disclosure requirements. For a similar comment in light of the *Schaeffler-Continental* case, see *Roger Kiem* Investorenvereinbarungen im Lichte des Aktien- und Uebernahmerechts, 54 AG 9 (2009) 301 ff.

[15] See *Theodor Baums* und *Maike Sauter* Anschleichen an Uebernahmeziele mit Hilfe von Aktienderivate, supra note 13, 464 ff., arguing that article 22.1 no. 2 is not applicable to cash settled equity swaps: first of all, direct ownership of hedge shares by the short party is possible, but not required; moreover, the voting rights relating to the hedge shares might be exercised (unless otherwise agreed) without following the long party's instructions; the short party may also adopt a non-voting policy, or lend the hedge shares to a third party for profit, or even sell the hedge shares to other bidders (possibly including "white knights"). For similar comments, see *Holger Fleischer* and *Klaus U. Schmolcke* Kapitalmarktrechtliche Beteiligungstransparenz und "Hidden Ownership", supra note 13, arguing that disclosure rules under German law do not cover cash settled derivatives, while excluding interpretation by analogy when resulting in the imposition of sanctions not explicitly provided by laws and regulations.

[16] See *Uwe H. Schneider* and *Tobias Brouwer* Kapitalmarktrechtliche Meldepflichten bei Finanzinstrumenten, supra note 14, 565, suggesting a principle-based approach to prevent rule elusive strategies. *Contra*, *Theodor Baums* and *Maike Sauter* Anschleichen an Uebernahmeziele mit Hilfe von Aktienderivate, supra note 13, 501 ff. arguing that a shift from rule-based to principle-based regulation would not be as effective as the extension of disclosure requirements, under article 25 of WpHG, to cash settled derivatives with higher relevant thresholds for similar instruments.

and similarities. Section 5 examines the Italian case of *EXOR-IFIL-FIAT*, which was decided (on grounds, however, not directly relevant to our discussion) by the Turin Court of Appeal in 2007, with a judgment recently confirmed by the Court of Cassation. Section 6 discusses the policy options for legal reform in this area and section 7 concludes.

II. The Case of *Ithaca* v. *Perry* (*Rubicon*)

This appears to be the first reported case on the treatment of equity derivatives from the perspective of major shareholdings disclosure.[17] *Perry*, a US investment adviser to hedge funds, was a major holder of shares in *Rubicon Ltd.*, a New Zealand public company. *Perry*'s investment philosophy was to invest in companies where they believed they could add value by supporting management.[18] In May 2001, *Perry* sold its shares (representing approximately 16 per cent of *Rubicon*'s voting capital) to two investment banks (*Deutsche Bank* and *UBS Warburg*) and simultaneously took the long side of equity swaps. Under the relevant transactions, the banks paid the 'equity amount' (i.e. the equity return on the underlying shares) and *Perry* paid the 'floating rate' (i.e. the financing cost of holding the underlying shares).[19] As a result, any negative movements in the share price had to be met by *Perry*.[20] At termination of the swap or 'unwind', a cash settlement occurred between the parties, with the exit price determined according to the criteria fixed by the relevant documentation.[21] After executing the swap transactions, *Perry* gave notice that it had ceased to be a 5 per cent holder in *Rubicon*, implicitly

[17] See *Ithaca (Custodians) Ltd.* V. *Perry Corp.*, [2003] 2 N.Z.L.R. 216 (H.C.), *rev'd*, [2004] 1 N.Z.L.R. 731 (C.A.); [2004] 2 N.Z.L.R. 182 (C.A.) (refusing conditional leave to appeal). For a description and commentary of the case, see *Hu and Black* The New Vote Buying, supra note 1, 836; and *Francesco Dialti* Equity Swaps ed obblighi di disclosure, Dir. Comm. Int. (2006), 428.

[18] See *Ithaca (Custodians) Ltd.* v. *Perry Corp.* (H.C.) supra note 17, at 7, specifying: 'They will frequently take a very active role with management, assisting with advice and strategies which *Perry* believes will enhance company value. This was the nature of the role they took in relation to investment in *Rubicon*'.

[19] Id. 49.

[20] Indeed, under an equity swap: 'If the underlying physical assets perform well the floating rate payer takes a profit. If the value of the underlying shares declines during the term of the contract, the floating rate payer must reimburse the loss to the equity amount payer. The equity amount payer receives a fixed margin for the service it provides.' In essence 'an equity swap enables the floating rate payer to invest in the economic performance of a security without many of the incidents attached to holding the physical security' (Id.).

[21] Id. 55.

assuming not to be a 'substantial security holder' any more.[22] *Deutsche Bank* and *UBS Warburg*, in turn, filed 'substantial security holder' notices, disclosing that they held certain voting shares in *Rubicon*. Those shares were kept by the two banks as a hedge for the equity swaps entered into with *Perry*, it being quite common for the equity amount payer to hedge its position to reduce risk.[23] Particularly where, as in the case of *Rubicon*, 'the underlying stock is relatively illiquid and not easily matched by similar shares, the equity amount payer will generally hold corresponding physical securities to match its economic exposure under the swap'.[24] However, a year later, *Perry* sought an early termination of the outstanding equity swaps, which were therefore 'unwound' by agreement between the parties.[25] *Perry* repurchased the relevant shares from the two banks, just in time to vote at the company's annual general meeting, and disclosed that it held 15.98 per cent of *Rubicon* under the relevant disclosure rules.

Just before the swaps' termination, another company, *GPG*, started buying shares in *Rubicon* with a view to taking an active role in its future direction.[26] *GPG* sought to establish a holding just under the threshold (20 per cent) for a mandatory bid. Before executing the purchases, a broker for *GPG* carried out some research to establish 'who were the major shareholders in *Rubicon* at that time, and in the light of the shareholding spread, whether and at what point *GPG* would be able to exercise significant influence in the company'.[27] The relevant inquiry did not reveal *Perry* as a substantial shareholder in the company, being based on the 'substantial security holder notices'. Therefore, *GPG* instructed its broker to acquire the requisite number of shares at a significant premium (13.6 per cent) over the then prevailing share price.[28] On July 4, *GPG* filed a substantial holder notice, notifying that it had acquired 19.87 per cent of the company. Only on July 8, did *GPG* come to know of *Perry*'s interest in the shares, which was

[22] Sec. 2 of the New Zealand Securities Markets Act defines a 'substantial security holder' as 'a person who holds a relevant interest in 5 per cent or more of a public issuer'. Sec. 5 defines very broadly 'relevant interest' in a voting security (see note 68 below).

[23] See *Ithaca (Custodians) Ltd.* V. *Perry Corp.* (H.C.) supra note 17, 49.

[24] Id. 51.

[25] Id. 84; see also at 114: 'Accessing the shares was a simple telephone call away in each case, followed by the requisite paper work and financial settlement to "unwind the swap"'. The reason why Perry wanted to repurchase the shares was 'to support *Rubicon* management, particularly in completing the *Fletcher Challenge Forest* transaction' (Id. 109).

[26] Id. 85. The reasons for *GPG*'s transaction are given at 86–88 and focussed on *Rubicon*'s 17.6 per cent shareholding in *Fletcher Challenge Forests*, in which *GPG* also had a direct holding. *Rubicon*'s management intended to dispose of their shares in *Fletcher Challenge Forests*, while *GPG* intended to prevent a similar transaction.

[27] Id. 89.

[28] Id. 90.

communicated to them by *Rubicon* in a meeting.[29] Three days later, *Perry* notified a holding of 15.98 per cent in *Rubicon*, as already indicated. As a result, *GPG* instituted proceedings, claiming that *Perry* had breached the law by failing to give notice of a relevant interest in *Rubicon*. *GPG* claimed damages to recover the premium it had paid for *Rubicon* shares and applied for orders that *Perry* be required to forfeit or sell down its shareholding to the 4.895 per cent level disclosed in its substantial shareholder notice on the 5 June 2001. Judge *Potter* of the High Court of Auckland found that the evidence did not support *Perry*'s contention that its move to equity swap transactions had been motivated largely by tax concerns. She rather found that the more significant reason for these transactions had been to avoid disclosure under the relevant regulatory provisions.[30] The Court also found that there existed an 'arrangement or understanding' between *Perry* and *Deutsche Bank* and *UBS Warburg* pursuant to which *Perry* had the power to acquire the shares in *Rubicon* held as hedges for the equity swaps.[31] In the Court's opinion: '... there was a consensus, a meeting of minds between *Perry Corporation* and the equity swap counter-parties that resulted in an arrangement or understanding that the *Rubicon* shares sold to *Deutsche Bank* and *UBS Warburg* on 31 May and to *Deutsche Bank* on 6 June when the equity swaps were established, were held available for repurchase by *Perry Corporation* for the duration of the equity swaps'.[32] Moreover, *Rubicon* had treated *Perry* as a major shareholder rather than as a party with significant economic interests in the company. *Rubicon* consulted with *Perry* regularly and was given to understand that the latter would be able to provide the support needed by way of voting power.[33]

[29] Id. 91–92.

[30] Id. 162 ff. (on why *Perry Corporation* entered into equity swaps); see, in particular, 182 where *Perry*'s CFO is quoted as saying: 'We don't want to broadcast our purchases and sales. It would be counter to the interests of our investors'; and the Court's comment: '*Perry Corporation* wanted to play their cards close to their chest. *Perry Corporation* made *Rubicon* aware of their attitude to disclosure and of the mechanism of equity swaps employed to avoid the requirements to disclose, while maintaining a significant economic interest in the company'.

[31] Id. 183 ff., highlighting the following circumstances: the swaps were entered into to avoid disclosure; *Rubicon* treated *Perry* as a major shareholder; *Perry* were confident that they could repurchase the shares; the shares were available for acquisition by *Perry* in several cases; *Perry* wanted to be able to vote their shares at *Rubicon*'s annual general meeting.

[32] Id. 219.

[33] Id. 194. However, Judge *Potter* held that *GPG* had not suffered any loss as a result of the non-disclosure by *Perry*. The premium it had paid had been necessary in order to acquire the shares overnight, so that there was no award for damages (Id. 254). At the same time, she found that the purpose of the relevant disclosure provision was both to compensate and deter. It was held, therefore, that orders should be made attempting to achieve the situation that *Perry* disclosed to the market, that is, as a holder of less than 5 per cent of

Perry appealed against these findings and orders. Their appeal was allowed by the Wellington Court of Appeal and the orders made by the Auckland High Court were set aside.[34] The Court of Appeal found that, if not inevitable, it was almost certain the *Rubicon* shares would be held by both banks involved as a hedge for the duration of the swaps.[35] The Court also found that the hedge shares would have been available for purchase by *Perry* if they wished to do so,[36] arguing that 'this market reality would have been obvious to any reasonably informed market participant'.[37] However, the Court held that the terms 'arrangement' and 'understanding', while describing something less than a formal contract, require a 'meeting of minds', which 'embodies an expectation as to future conduct, meaning that there is consensus as to what is to be done. This necessarily involves communication. The communication does not, however, need to be formal or even verbal'.[38] With respect to the case at issue, the Court concluded: 'As there must be a meeting of minds and communication, mutual expectations based on commercial reality (but without such consensus or communication) are not sufficient to give rise to an arrangement or understanding'.[39] The Court also motivated in terms of policy: '... if we hold that knowledge of market reality suffices ... and that consensus and communication are not required, this would create uncertainty as to the scope of disclosure generally ... [and] mean that the majority of equity swaps in New Zealand would create disclosure requirements, whether cash-settled or not. There are obvious policy issues involved in extending disclosure requirements to interests under equity swaps as the regime conceptually is directed at voting rights rather than economic interests. Most equity swaps only create economic interests'.[40]

III. The Case of CSX Corporation et al. v. The Children's Investment Fund et al.

This was the first US case[41] adjudicating the issue whether the long party of an equity swap is obliged to disclose its position under the ownership

the company (Id. 265). As a result, *Perry* was required to forfeit one third of the shares for which the swap agreements had been executed and to sell the remaining two thirds (Id. 262–268).

34 See *Ithaca (Custodians) Ltd.* V. *Perry Corp.* (C.A.) supra note 17.

35 Id. 60.

36 Id. 61–66.

37 Id. 66.

38 Id. 69.

39 Id. 73.

40 Id. 76.

41 See *CSX Corporation* v. *The Children's Investment Fund Management (UK) LLP*, et al., S.D.N.Y. 08 Civ. 2764 (June 11, 2008), 562 F. Supp. 2d 511. For a commentary, see

disclosure rules enacted by the Williams Act.[42] The defendants (collectively defined as *The Children's Investment Fund* or *TCI* and *3G*, respectively) were two activist hedge funds, which had amassed a large economic position in *CSX*, one of the nation's largest railroads. As found by Judge *Kaplan*: 'They did so for the purpose of causing *CSX* to behave in a manner that they hoped would lead to a rise in the value of their holdings. And there is nothing wrong with that. But they did so in close coordination with each other and without making the public disclosure required of 5 per cent shareholders and groups by the Williams Act, a statute that was enacted to ensure that other shareholders are informed of such accumulations and arrangements'.[43] *TCI* made an initial investment in *CSX* in October 2006 by entering into total return swaps referencing 1.7 per cent of *CSX* shares. They immediately informed *CSX* of their acquisition and sought a meeting with senior management of the same. In the meantime, *TCI* continued to engage in swap transactions referenced to *CSX* shares with various counterparties, reaching 8.8 per cent of the share capital by the end of 2006.[44] In November they met *CSX* representatives and later informed the same that the relevant swaps 'could be converted into direct ownership at any time'.[45] In 2007 *TCI* investigated the possibility of a leveraged buyout proposal and met with *CSX* financial advisors to discuss the same. *CSX* reacted by saying that they were not in a position to respond and later announced a plan to buy back a substantial quantity of their common stock. *TCI* went on accumulating economic interests in *CSX* and contacted other hedge funds to promote the acquisition of *CSX* shares.[46] In the meantime, they had not abandoned the idea of taking *CSX* private in an *LBO* and exerted pressure on *CSX* management to alter the company's practices in a manner that would cause its stock to rise.[47] However, *CSX* showed little interest in an LBO, '[s]o *TCI* by this time understood that a proxy fight likely would be required to gain control of or

Daniel Bertaccini To Disclose or Not to Disclose? CSX Corp., Total Return Swaps, and Their Implications for Schedule 13S Filing Purposes, 31 Cardozo L. Rev. 267 (2009); *John Armour* and *Brian Cheffins* The Rise and Fall (?) of Shareholder Activism by Hedge Funds (September 1, 2009), ECGI – Law Working Paper No. 136/2009, available at SSRN:http://ssrn.com/abstract=1489336; CSX/TCI Decision Webcast, available at: http://blogs.law.harvard.edu/corpgov/2008/08/12/csx-decision-webcast/

42 Act of July 29, 1968, Pub. L. No. 90-439, § 2, 82 Stat. 454 (1968). As argued by Judge *Kaplan* in the case at issue (Id. 537), the Williams Act 'was passed to address the increasing frequency with which hostile takeovers were being used to effect changes in corporate control'.

43 Id. 517.

44 Id. 523.

45 Id. 524.

46 Id. 525.

47 Id. 526.

substantial influence over *CSX*'.[48] *CSX* started preparations for a proxy fight by engaging advisors, recruiting candidate directors and addressing the matter of its voting power.[49] On December 19, 2007, *TCI*, *3G* and three nominee directors of *CSX* disclosed that they intended to conduct a proxy solicitation.[50]

As a result, *CSX* brought an action against *TCI* and *3G* seeking, among other things, an order requiring corrective disclosure, voiding proxies defendants had obtained, and precluding defendants from voting their *CSX* shares. *TCI* and *3G* defended their secret acquisition of interests in *CSX* by arguing that they did not beneficially own the shares referenced by the swaps and thus were not obliged to disclose. Similarly, they contended that they had not reached a formal agreement to act together and therefore had not become a group required to disclose its collaborative activities. The relevant disclosure duties are found in Section 13 of the Securities Exchange Act. Section 13(d)(1) places these duties upon 'any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 78*l* of this title, ... is directly or indirectly the beneficial owner of more than 5 per centum of such class ...'.[51] In order to prevent circumvention of this section, Section 13(d)(3) further provides that '[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection'. The concept of 'beneficial ownership' is central: '[a]lthough Congress did not define the term, its intention manifestly was that the phrase be construed broadly'.[52] The *SEC* did so by providing in its Rule 13d-3(a) that '... a beneficial owner of a security includes any person who, directly or indirectly, through contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of,

[48] Id. 526.

[49] Id. 529. In particular, *TCI* shifted equity swap exposure equal to approximately 9 per cent of *CSX* from other counterparties into *Deutsche Bank* and *Citigroup*.

[50] Id. 535.

[51] Section 13(d)(1) goes on to state that the beneficial owner shall, within ten days after such acquisition, send to the issuer of the security at its principal executive office and to each exchange where the security is traded, and file with the Commission, a statement containing the information that the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. The prescribed information shall relate to the beneficial ownership's nature, to the purpose of purchases and to the number of shares beneficially owned.

[52] See *CSX Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 46.

such security.' The *SEC* intended its rule to provide a 'broad definition' of beneficial ownership so as to ensure disclosure 'from all those persons who have the ability to change or influence control'.[53] As argued by Judge *Kaplan* in the case at issue, the words used in the definition 'demonstrate the focus on substance rather than on form or on the legally enforceable rights of the putative beneficial owner'.[54] Furthermore, the *SEC*'s effort 'to capture all situations in which the marketplace should be alerted to circumstances which might result in a change in corporate control'[55] led to the adoption of Rule 13d-3(b) covering any arrangement to divest a person of beneficial ownership or to prevent the vesting of beneficial ownership as part of a plan or scheme to evade the reporting requirements.[56] Any person using similar arrangements shall be deemed to be the beneficial owner of the relevant security.[57]

As the Court acknowledged, the swaps did not give *TCI* any legal rights with respect to the voting or disposition of *CSX* shares referenced therein; nor did they require that the swap dealers acquire *CSX* shares to hedge their positions. However, the beneficial ownership 'inquiry focuses on any relationship that, as a factual matter, confers on a person a *significant ability to affect* how voting power or investment power will be exercised, because it is primarily designed to ensure timely disclosure of market-sensitive data about changes in the identity of those who are able, as a practicable matter, to influence the use of that power'.[58] As to investment power, the Court found that it was 'inevitable' that the swap counterparties 'would hedge the *TCI* swaps by purchasing *CSX* shares'.[59] Moreover, the fact that the transactions were cash settled swaps did not mean that they would be settled in cash, as *TCI* and its counterparties could 'agree to unwind the swaps in kind, i.e., by

[53] See Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release Nos. 33-5925, 34-14692, 43 Fed. Reg. 18,484, 18,489 (Apr. 28, 1978).

[54] See *CSX Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 540.

[55] *Id.*

[56] See Adoption of Beneficial Ownership Disclosure Requirements, Exchange Act Release Nos. 33-5808, 34-13291, 42 Fed. Reg. 12,342, 12,344 (March 3, 1979).

[57] In this respect, the question was also discussed in the case at issue whether for Rule 13d-3(b) to apply the relevant activity must involve holding a position which is beneficial ownership under the statute, but would for some reason fall outside the scope of Section 13(d). See, for an affirmative answer, letter of Professor *Bernard Black* to the SEC, 29 May 2008, re: *CSX Corp.* v. *The Children's Investment Fund* et al. The Court, however, answered in the negative arguing that '[i]f Rule 13d-3(b) reaches only situations that involve beneficial ownership, then it reaches only situations that are reached by Rule 13d-3(a). Professor *Black*'s view thus would render Rule 13d-3(b) superfluous' (see *CSX Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 551).

[58] See *SEC* v. *Drexel Burnham Lambert Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y.), cited by Judge *Kaplan* in CSX *Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 540.

[59] *CSX Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 541.

delivery of the shares to *TCI* at the conclusion of each transaction, as indeed commonly occurs'.[60] In any case, assuming cash settlement, the counterparties would sell the hedge shares at the conclusion of the swaps so as to avoid the risk of holding the physical shares without the downside protection of the swap.[61] As to voting power, the Court admitted that the situation was 'a bit murkier' and yet there was reason to believe that *TCI* was in a position to influence the counterparties with respect to the exercise of their voting rights.[62] In general, *TCI* selected counterparties that would be most likely to vote with them in a proxy contest.[63] Moreover, some of the banks' policies gave *TCI* the power to prevent the shares from being voted.[64] In addition, there was evidence that *TCI* had created and used the swaps, at least in major part, for the purpose of preventing the vesting of beneficial ownership of *CSX* shares and as part of a plan to evade the relevant reporting requirements.[65] Therefore, the Court found that under Rule 13d-3(b) *TCI* was deemed to be a beneficial owner of the shares held by its counterparties to hedge their short exposures created by the equity swaps.[66]

IV. A Brief Comparison

The two cases just examined present striking similarities. First of all, they both involved active investors, hedge funds in particular, seeking to maximize the value of their shares by influencing the target companies' management. Moreover, the relevant investors, in both cases, tried to hide their substantial ownership interests in the target companies by entering into equity swaps with several dealers, so as to avoid all applicable disclosure requirements. At the same time, the dealers hedged their short positions by purchasing the referenced shares and holding the same until the swaps' expiry. In the case of *Perry/Rubicon*, the swaps were subsequently terminated by the long party and the hedge shares were transferred to the same, who was then able to exercise the relevant voting rights. In the case of *TCI/CSX*, the long party of the swaps orchestrated a proxy fight by concentrating the swap agreements in two counterparties, one of which was, as the Court found, 'exceptionally

60 Id.

61 Id. at 542, concluding: 'On this record, it is quite clear that *TCI* significantly influenced the banks to purchase the *CSX* shares that constituted their hedges because the banks, as a practical matter and as *TCI* both knew and desired, were compelled to do so. It significantly influenced the banks to sell the hedge shares when the swaps were unwound for the same reason'.

62 Id. at 546.

63 Id. at 545.

64 Id.

65 Id. at 548.

66 Id. at 551.

receptive, to say the least, to *TCI*'s goals and methods'.[67] In addition, the legal regimes applicable to the two cases at issue are remarkably similar. Under New Zealand law, a 'substantial security holder' (i.e., the holder of a 'relevant interest' in a given security) is bound to disclose its holding. The concept of 'relevant interest' is broadly defined by sec. 5 of the New Zealand Securities Market Act, also with reference to 'beneficial ownership' and to any 'arrangement or understanding' under which a person may have the power to acquire, or dispose of, the securities at issue.[68] An even broader definition is found in the rules adopted by the SEC to specify the concept of 'beneficial ownership', also covering any arrangement to divest a person of beneficial ownership or to prevent the vesting of the same as part of a plan or scheme to evade the reporting requirements.

As a result, the opinions of *Potter* J. of the Auckland High Court and *Kaplan* J. of the Southern District of New York converge in asserting the prevalence of substance over form. As argued by the latter in the introduction to his opinion: 'Some people deliberately go close to the line dividing legal from illegal if they see a sufficient opportunity for profit in doing so. A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law. This is such a case'.[69] Judge *Kaplan* found clear support for his argument in the SEC's provisions referred to above (sec. 3), demonstrating 'the focus on substance rather than form or on the legally enforceable rights of the putative beneficial owner'.[70] Judge *Potter* also relied on the New Zealand rules setting the onus of proof, under that part of the Securities Markets Act dealing with disclosure of substantial security holder interests in public issuers, at a lower level than that required in civil proceedings.[71] On the basis of similar rules, she found that there was 'a consensus, a meeting of minds' that resulted in 'an arrangement or understanding' that the *Rubicon* shares sold to *Deutsche Bank* and *UBS Warburg* when the equity swaps were established 'were held available for repurchase by *Perry Corporation* for the duration of the equity swaps'.[72] The main argument for reaching her conclusion seems to have been that the more

67 Id. at 529.

68 In particular, a 'relevant interest' arises when a person is the beneficial owner, has the power to exercise or to control the right to vote attached to the voting security, has the power to acquire or dispose of the voting security, or 'under, or by virtue of, any trust, agreement, arrangement or understanding relating to the voting security ... may at any time have the power to acquire, or dispose of, the voting security'.

69 *CSX Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 511.

70 See note 46 above and the accompanying text; see also *CSX Corporation* et al. v. *The Children's Investment Fund* et al., note 41 above, at 517, where Judge *Kaplan* says: '[t]he Exchange Act is concerned with substance, not incantations and formalities'.

71 See *Ithaca (Custodians) Ltd. V. Perry Corp.* (H.C.), supra note 17, at 221.

72 Id. at 219.

important and significant reason for entering into the equity swaps was to avoid disclosure: '*Perry Corporation* wanted to play their cards close to their chest. Meeting the disclosure requirements of the Act did not suit that intent and purpose'.[73] However, the Wellington Court of Appeal reversed the High Court's judgment and found that for an arrangement or understanding to exist there must be some form of 'communication' – not necessarily formal, nor verbal – between the parties, which was, in the Court's opinion, lacking in the circumstances of the case.[74] Without venturing into an assessment of which of the two Courts' readings of the law was more appropriate under New Zealand law, I submit that the Appeal decision came to prefer form over substance. It is also possible that the Court of Appeal was, to some extent, guided by the desire not to negatively affect the derivatives market by fixing too stringent criteria, which could have led to the disclosure of all equity derivatives positions, including those *de facto* not allowing any voting power to the long party.[75]

V. The Case of *Exor/IFIL* v. *Consob* (*FIAT*)

A similar tension between substance and form is found in the case of *EXOR/IFIL* v. *Consob*. The facts were similar to those of the two other cases just examined, except that in the present case the long party of the equity swap was an insider (controlling shareholder) rather than an activist investor (hedge fund).[76] The company concerned was *FIAT S.p.A.*, Italian holding of an international group manufacturing cars and other vehicles, controlled by the *Agnelli* family through a chain of companies including *IFIL*, which owned about 30 per cent of *FIAT*'s ordinary capital.[77] In 2002, a pool of

[73] Id. at 182.

[74] See *Ithaca (Custodians) Ltd.* V. *Perry Corp.* (C.A.), supra note 17, at 73–78.

[75] Id. at 77.

[76] On hedge fund activism see *Marcel Kahan* and *Edward B. Rock* Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021 (2007); *William Wilson Bratton* Hedge Funds and Governance Targets, 95 Geo. L.J. 1375 (2007); *Brav Alon, Jiang Wei, Thomas S. Randall* and *Frank Partnoy* Hedge Fund Activism, Corporate Governance, and Firm Performance 63 JF Vol. 1729 (2008); and ECGI – Finance Working Paper No. 139/2006, available at SSRN: http://ssrn.com/abstract=948907 (last accessed on 19 november 2009).

[77] See Corte d'Appello di Torino, Sez. I, 5 December 2007, on Bollettino Consob, n. 2.1, 1–15 February 2008, available at www.consob.it. For commentaries on the case see *Salvatore Bragantini* Se l'Equity Swap Dribbla la Comunicazione, 29 September 2009; *Roberto Ceredi* Se il Mercato non ha Notizie, both available at www.lavoce.info; and *Francesco Caputo Nassetti* I Contratti Derivati Finanziari, 511–512 (Giuffrè 2007). For a legal analysis see *Lisa Curran* and *Francesca Turitto* FIAT/IFIL: The Securities Law Implications for Equity Derivatives, 7 JIBFL 297 (2006); *Guido Ferrarini* Prestito titoli e derivati azionari nel governo societario, supra note 2, 663.

banks granted to *FIAT* a three-year loan of 3 billion euro, which had to be reimbursed in *FIAT*'s shares to be issued through an *ad hoc* capital increase, save for the possibility to repay the loan in cash. In spring 2005, *FIAT*'s stock price fell to an historical low, making it likely that the loan would be 'converted' into shares. However, the issuance of the new shares would have diluted *IFIL*'s shareholding in *FIAT* well below 30 per cent, which traditionally allowed the *Agnellis* to control the company. As the *Agnellis* intended to stay in control, a plan was devised to increase their economic interest in *FIAT* at the favourable market conditions prevailing at that time, whilst avoiding the launch of a bid, which would have become mandatory if their stake in *FIAT* had mounted to more than 30 per cent of the voting capital. *EXOR*, another company of the *Agnelli* Group, came into play and made an investment in *FIAT* by entering into a cash-settled equity swap with *Merril Lynch*, referenced to about 8 per cent of *FIAT*'s ordinary capital. The swap was made on the same day when *FIAT* announced that the 3 billion bank-loan would have been converted into shares. Nonetheless, the transaction was subsequently explained by those who engineered it as a good trading opportunity for *EXOR*, given the low valuation of *FIAT* shares, rather than an investment made in support of *IFIL*.

Merril Lynch hedged its exposure to *EXOR* by purchasing *FIAT* shares on the market and also executing equity swaps referenced to *FIAT* shares with other dealers. As a result, *Merril Lynch* publicly notified its shareholding in *FIAT* after crossing the 2 per cent threshold provided for by the Italian rules on substantial shareholdings, but did not make further disclosures for crossing the 5 per cent threshold, as this was accomplished through equity swaps. For similar reasons, *IFIL* did not launch a mandatory bid for the remaining ordinary capital of *FIAT*, assuming that the relevant rules would have been applicable only if the transaction with *Merril* had been in the nature of a physically settled swap, which was not the case. In the summer of the same year, however, *EXOR* negotiated with *Merril Lynch* a way to terminate the swap and possibly transfer the hedge shares to *IFIL*, so as to avoid the dilution of *IFIL*'s shareholding as a result of the new issuance of *FIAT* shares to the benefit of the banks. Similar negotiations led the parties to change the equity swap from 'cash-settled' to 'physically settled', which allowed the transaction to be unwound by attributing the hedge shares to *EXOR*, who subsequently transferred the same to *IFIL*. As a result, *IFIL* kept control over *FIAT* without in any moment crossing the 30 per cent threshold and therefore avoiding the launch of a mandatory bid.

The transaction was no doubt brilliant and effective from the Agnelli's perspective. Was it, however, also compliant with the Italian requirements on shareholdings' disclosure and mandatory bids? *Consob*, the securities regulator, did not object to the transaction at issue after becoming aware of the same, implicitly assuming – as did the parties to the transaction – that equity swaps were neither subject to shareholdings disclosure, nor relevant for mandatory bids.[78] Nonetheless, *Consob* sanctioned *IFIL* and some of its directors for misleading disclosures made, in response to specific requests from *Consob*, when negotiating with *Merril* the swap's unwinding and the purchase of the hedge shares.[79] *Consob*'s general view of the regime applicable to equity derivatives, recently confirmed by the Commission in a position paper,[80] focuses on legal form, assuming that the swap dealer is neither bound to purchase the referenced shares, nor to vote the same, when held as hedge shares, on behalf of the long party.

As I argued in another paper, however, the Italian regime lends itself to a different reading.[81] In fact, *Consob*'s Regulation on Issuers makes the disclosure rules applicable also to cases in which the relevant shares are held, either totally or in part, through a third party acting as either a fiduciary or 'interposta persona' (nominee).[82] The concept of 'interposta persona' was analysed by Italian scholars along two different lines of thought. On the one side, those adhering to the 'private law view' of this concept, argued that an 'interposta persona' can be found only if the same is legally bound to transfer the shares back to the beneficiary. In other words, an agreement must be made between the nominee and the beneficial owner, under which the former is obliged to transfer the shares back, upon request or at a stated term.[83] This was also *Consob*'s opinion in the case examined above. On the other side, those favouring a 'capital markets view' of 'interposta persona', argued that this concept should be interpreted functionally (i.e., with regard to the purpose of disclosure rules), focussing on the substance of the transaction at issue.[84] Indeed, investors are interested to know the real allocation of voting power. As a result, disclosure is required also from the beneficial owner of the relevant shares, if the same has – either legally or *de facto* – voting power with respect to those shares.[85] By subscribing to this 'capital markets' view of

[78] See Comunicato Consob, 7 February 2006, on Notiziario settimanale della Consob, n. 7 of the 13 February 2006.

[79] See Delibera Consob, n. 15760 of the 9 February 2007, which referred to the misleading communications given by IFIL and some of its directors; Delibera Consob, n. 16068 of the 1 August 2007, regarding EXOR and some of its directors; both available at www.consob.it.

[80] See Position Paper Consob "in tema di trasparenza proprietaria sulle posizioni in derivati cash-settled", 8 October 2009, available at www.consob.it.

[81] See *Guido Ferrarini* Prestito titoli, supra note 2, p. 654 ff.

[82] See Article 118 of Consob's Regulation on Issuers.

[83] See *Giuseppe Sbisà* Società e imprese controllate nel d.l. 9 aprile 1991, n. 127, in Riv. Soc., 1992, p. 906, at 913; *Paolo Benazzo* I presupposti dell'o.p.a. preventiva, in Giur. Comm., 1994, I, 116, at 133.

[84] See *Paolo Ferro-Luzzi* Art. 9, commal e 2, l. 281/85: prime considerazioni esegetiche, in Banca, borsa, 1986, I, 425, at 433; *Luca Enriques* Mercato del controllo societario e tutela dell'investitore (Bologna 2002) 57 ff.

[85] See *Guido Ferrarini* Prestito titoli, supra note 2, 656.

'interposta persona', I argued in my other paper that the Italian regime can be seen as not too different from that examined in the case of *Perry/Rubicon* analysed above.[86] I also argued that an Italian court could have decided the same case in a way similar to that followed by the Auckland Court, by looking at the substance of the equity swap transactions in light of all evidence available as to the parties' behaviour.[87] A similar comment can now be made with reference to Judge *Kaplan*'s decision in the case of *CSX* v. *TCI*, which was no doubt made possible by the far-reaching anti-fraud provision found in the *SEC*'s disclosure rules, which allow a court to unmask the specific goals pursued through an equity swap transaction.[88]

VI. Policy Perspectives

It is now possible to briefly consider how a regulator (be it the European Commission or a domestic regulator) should treat, *de iure condendo*, the problem analyzed in this paper, i.e. whether and under what conditions equity derivatives should be subject to the transparency regime applicable to important shareholdings. There are at least two policy options available, reflecting the well-known distinction between standards and rules. The first option is best exemplified by the *SEC* regime examined above (sec. 4), which is grounded on a 'general clause' with an anti-fraud character. Not only are beneficial owners subject to the relevant transparency provisions, but also '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 ...'.[89] As argued by Judge *Kaplan*, this provision is broad enough to justify the imputation of disclosure duties to the long party of an equity swap transaction, even if the same cannot be defined as a beneficial owner. Indeed, it is sufficient for the equity swap to be part of a plan or scheme to evade the reporting requirements. A similar strategy is reflected by the New Zealand and Italian regimes considered above (sec. 3 and 5, respectively), even though the standards marking the scope of those regimes (such as the concept of 'interposta persona' in Italy) are less explicit and therefore potentially

[86] Id.

[87] The same evidence was valued differently by the Wellington Court of Appeal, supra notes 38 and 39, in a judgement which seemed to prefer form over substance: see sec. 4 above.

[88] Supra note 52 and accompanying text.

[89] Rule 13(d)(3) of the Securities Exchange Act.

narrower than that adopted by the *SEC*. The second policy option is well exemplified by the recent UK reform, substantially attracting all cash-settled equity derivatives to the transparency regime of important shareholdings.[90] This solution is grounded on a 'rule' strategy, to the extent that no discretion is left for determining whether the long party in an individual transaction falls under the disclosure duties. Indeed, the criteria adopted are specific enough for not requiring an *ex post* assessment of whether a given transaction falls under the relevant rules.

The choice between these two strategies should be made according to parameters already discussed by law and economics scholars.[91] Standards leave private parties to decide what course of action to follow amongst those potentially falling within the scope of a standard. The private decision maker will likely try to exercise sound judgment, for a wrong decision would expose him to sanctions. A similar regulatory strategy can be followed in the following circumstances: (i) the private parties have access to information that the regulator does not know or cannot acquire at low cost; (ii) the conducts to regulate are potentially diverse and cannot be easily described *ex ante*; (iii) the conducts to regulate are not frequent, so that specifying the applicable rule *ex post* is not too costly. When, on the contrary, the regulator is sufficiently informed and/or possible conducts can be easily identified *ex ante* or the applicable rules are easily identified *ex post*, a rule strategy can be followed, with lower compliance costs to the interested parties. However, if the regulator gets the rule wrong, also situations shall be affected which do not generate the negative effects that the rule is designed to address (false positives). In any case, enforcement is easier for rules than for standards, as the former are more precise and do not require further specification.[92]

Also in the case of equity derivatives, therefore, a regulator should compare the costs of promulgating a rule with those of enforcing a standard. A rule like the UK one, requiring disclosure of long positions in almost all cases,

[90] See FSA Handbook, DTR 5.3.1: 'A *person* must make a notification in accordance with the applicable thresholds in DTR 5.1.2R in respect of any *financial instruments* which they hold, directly or indirectly, which: (a) are qualifying *financial instruments* within DTR 5.3.2R; or (b) unless (2) applies: (i) are referenced to the *shares* of an *issuer*, other than a non-UK issuer; and (ii) have similar economic effects to (but which are not) qualifying *financial instruments* within DTR 5.3.2R'. See also DTR 5.3.3 (2): 'For the purposes of DTR 5.3.1 R (1) (a), in the FSA's view: (a) a *financial instrument* has a similar economic effect to a qualifying *financial instrument* in DTR 5.3.1. R (1)(a), if its terms are referenced, in whole or in part, to an *issuer's shares* and, generally, the holder of the *financial instrument* has, in effect, a long position on the economic performance of the *shares*, whether the instrument is settled physically in *shares* or in cash …'.

[91] See, for all, *Louis Kaplow* Rules versus Standards: An Economic Analysis, 42 Duke Law Journal (1992), 557.

[92] Id. arguing that 'rules cost more to promulgate; standards cost more to enforce'.

inevitably reaches also to situations where similar disclosure duties are not needed. As a result, compliance costs tend to be higher, for situations must be disclosed which would remain secret if a standard (like the US one) were applicable. However, a standard creates greater enforcement costs, for a regulator (or a court) must look *ex post* for evidence of the fraudulent intent pursued by the parties, as seen in the cases examined above. In conclusion, a choice between rules and standards must be based on the comparison between two sets of costs: compliance costs, which mainly depend on the scope of disclosure, and enforcement costs, which depend on the frequency of relevant cases and the difficulties in collecting evidence of violations.

VII. Concluding Remarks

This paper has analyzed three international cases concerning the question whether and under what conditions the regulation of important shareholdings' disclosure should refer to the substance of equity derivatives transactions. The cases regard either hedge funds secretly taking over a company or controlling shareholders striving to maintain control. In all cases considered, the applicable legal regimes include standards that allow a court to unmask the real purpose pursued by the parties when entering into an equity derivative transaction. If avoidance of the provisions on major shareholdings' disclosure was the main purpose pursued by the parties, disclosure of the long position in the relevant shares is required. In fact, situations may occur in which the legal form of a derivative transaction does not fully coincide with its substance. For example, there may be a tacit understanding between the parties of an equity swap that the hedge shares will be transferred back to the long party upon simple request (or that the same shares will be voted according to the long party's instructions). Though legally unenforceable, a similar understanding could be considered by the parties as binding on social and reputational grounds. Indeed, law and economics scholarship has shown that markets may exist and function also in the absence of legal rules, thanks to reputational mechanisms that are sometimes more effective than the legal ones.[93]

Also in the cases considered throughout this paper, the short parties of equity swaps were led by economic incentives and reputational mechanisms to execute actions not formally required by the agreements at issue. How these incentives and mechanisms operate is easily explained. Firstly, it is hard

[93] See, in particular, *Lisa Bernstein* Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions, 99 Michigan Law Review (2001) 1724.

to imagine an investment bank, as swap dealer, refusing to sell the hedge shares to the long party, if the latter is an important client of the bank and needs those shares to complete a takeover. Secondly, investment banks frequently market equity derivatives to potential clients as tools for secretly accumulating shareholdings in a listed company; as a result, clients expect banks to cooperate in seeking the success of their corporate acquisitions, either selling back the hedge shares or voting the same in the client's interest. Thirdly, if the market for the relevant shares is neither sufficiently liquid nor deep, the short party may find it difficult to sell the hedge shares to counterparties other than the long party. Of course, the main difficulty in enforcing the antifraud standards at issue is that of proving the true intent pursued by the parties to an equity derivative transaction. The cases analyzed in this paper may help to identify the circumstances representing the likely indicia for a similar finding by either a regulator or a court, which obviously include the behavior of the parties in the performance and unwinding of their transactions.