

Improving Australia's Framework for Disclosure of Equity Derivative Products

Determining the degree of effective control
obtained through equity derivatives
and identifying appropriate disclosure requirements

Issues Paper
June 2009

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FOREWORD



Effective and comprehensive ownership disclosure provisions are important for the transparency and integrity of Australia's financial markets. Australia already boasts a well developed disclosure framework to regulate the information provided to the market about the ownership of listed companies and managed investment schemes.

In the interest of enhancing Australia's ownership disclosure regime, the Prime Minister announced that the Rudd Government is committed to addressing concerns that certain innovations in our financial system, such as the use of equity derivatives, could undermine transparency in Australia's markets.

The Government has released this issues paper as part of an assessment of the adequacy of existing disclosure provisions in the context of growing usage of equity derivatives in Australian markets.

The issue of non-disclosure of equity derivatives has become a significant one in the context of the rising need for effective financial market regulation, as highlighted by recent Group of Twenty (G20) discussions. In current market conditions, transparency is more important than ever to ensure the integrity of our markets.

Recent domestic and overseas developments involving equity derivatives have alerted the Government to the need for greater transparency of positions held through equity derivatives. The potential for investors to use these instruments to circumvent disclosure requirements normally associated with direct stakes calls for a thorough assessment of the existing disclosure framework.

Since the existing framework was devised, there has been significant development in the use of equity derivatives. Growth in the use of these instruments potentially challenges the ability of the current framework to adequately regulate disclosure.

The Government acknowledges that equity derivatives have become a significant feature of financial markets in both Australia and overseas. Furthermore, there has been substantial development and innovation in these products. The rising importance of equity derivatives calls for a balanced approach in which any legislative approach should ensure adequate and appropriate disclosure whilst not stifling innovation.

The Rudd Government is committed to promoting investor confidence and the integrity of Australia's financial markets. I welcome submissions from stakeholders on the issues outlined in this paper.

A handwritten signature in black ink, appearing to read 'Nick Sherry', with a long horizontal flourish extending to the right.

Senator Nick Sherry
Minister for Superannuation and Corporate Law

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1 EXECUTIVE SUMMARY

1.1 PURPOSE

1. The Australian Government acknowledges the need for effective financial market regulation, as highlighted by G20 discussions. The Government considers enhanced transparency is of major importance to the fairness and integrity of Australian financial markets and to the broader economy.
2. The Government is keen to ensure that Australia's regulatory regime meets the challenges to adequate disclosure posed by innovation in the financial system, and in particular by the increased use of equity derivatives. In 2008, the Prime Minister called attention to potential shortcomings in current ownership disclosure legislation that permit holders of equity derivatives to circumvent disclosure provisions normally associated with direct stakes. He announced that Treasury would undertake an assessment of Australia's disclosure requirements for equity derivatives.
3. Treasury has undertaken a preliminary consideration of this matter and has produced this Issues Paper as the first public step in the assessment to guide consultation with stakeholders on several issues related to equity derivative disclosure. The views expressed in this paper do not represent a final policy position.
4. At this initial stage, issues are introduced at a high level in order to determine their relative practical importance. Treasury welcomes stakeholder comments and factual input on these issues, which are outlined below.

1.2 ADEQUACY OF EXISTING DISCLOSURE REGIME

5. The current ownership disclosure framework essentially requires disclosure where an investor can vote or influence voting. It was devised at a time when the calculation of ownership was relatively straightforward. Since then, significant development in the use of equity derivatives challenges the ability of the current framework to adequately regulate disclosure.
6. Although the *Corporations Act 2001* forms an adequate disclosure regime for direct share and voting interests, recent events and regulatory developments in Australia and overseas demonstrate the potential for investors to circumvent normal disclosure provisions through the use of equity derivative instruments.

1.2.1 Substantial holder notice provisions

7. Holders of direct stakes in listed companies and managed investment schemes are required to disclose substantial interests, but it appears that holders of substantial equity derivative positions often are not, even though they may have effective control over those shares or interests. The assessment will explore whether disclosure of substantial equity derivative positions should be required to reflect the fact that, while equity derivatives give economic interests but not voting rights, they may give a degree of effective control over the referenced shares. (Please note that when this issues paper refers to 'underlying shares' or 'referenced shares', it means to include interests

in listed vehicles including companies and managed investment schemes referenced by equity derivative products.)

Cash-settled equity derivatives and effective control

8. Cash-settled equity derivatives potentially represent an important challenge to the current disclosure framework. Generally there appears to be no requirement to disclose such equity derivative positions under the existing law.
9. Practical considerations, however, may mean that the derivative holder has a significant degree of effective control over the underlying shares. The issuer of the derivative may hedge its risk by taking a physical interest in the referenced shares.
 - There is nothing preventing the issuer from eventually selling this parcel directly to the holder of the contract at maturity.
 - The fact that the issuer buys the referenced shares as a hedge, so they are removed from the market, may have significant effects on the market even if they are not eventually sold to the holder.
 - The derivative holder may also influence the issuer in the exercise of voting rights attached to those shares.

Separation of voting from economic interests

10. Equity derivatives may separate voting from economic interests in a company. This may lead to situations in which investors with no beneficial interests in the firm are able to vote or in which investors with no voting rights are exposed to the economic outcomes of ownership.
11. The separation of ownership rights is not itself necessarily a concern. Indeed, these are widely accepted and desired features of equity derivatives contracts among investors. The assessment will consider whether these arrangements should be disclosed.

1.2.2 Other disclosure requirements

12. In the context of disclosure more broadly, a range of other issues arise. The Government seeks disclosure and transparency which is of a practical benefit. This Issues Paper considers other provisions in the *Corporations Act 2001* whose effectiveness may be challenged in the context of non-disclosure of equity derivatives.
 - *Takeovers*: The market for corporate control is an area in which non-disclosure of control and voting interests can potentially have significant detrimental effects on the transparency and order of the market. The integrity of the takeover provisions in the Corporations Act 2001 rests in part on adequate disclosure of relevant interests.
 - *Tracing notice provisions*: Current rules require investors to disclose any relevant interests in a listed company. The definition of relevant interest, however, does not appear to include derivative interests. The potential therefore exists that tracing notices will fail to detect 'effective' owners who have an interest in the referenced shares through a derivative.
 - *Director disclosure provisions*: It appears that current rules do not require director disclosure of equity derivative positions referenced to the relevant company's

shares. In other words, directors could acquire or dispose of their interests through the use of equity derivatives and not be required to disclose these dealings.

1.3 TIMING AND AUDIENCE

13. The Government invites comment and factual input from all stakeholders, including investors, traders, issuers of shares, issuers of equity derivative instruments, industry groups, brokers, banks and any other individuals or financial institutions that have a view on the issues raised in this document.
14. Comments and factual input can be made in writing by 31 July 2009.

2 FRAMEWORK

2.1 AIMS

15. The Australian Government is keen to ensure that a sound regulatory framework exists for the disclosure of substantial holdings in listed companies and managed investment schemes, both through direct stakes and through equity derivative instruments.
16. This assessment will examine whether long equity derivatives can give a degree of effective control over referenced shares and, if so, whether that control could have important influences that mean derivative positions should be disclosed. The assessment will also consider whether short equity derivatives positions should be disclosed and determine the basis on which such disclosure could be required.
17. More particularly, this assessment will:
 - determine whether current provisions allow for investors and companies to be adequately informed about the ownership and control of listed companies and managed investment schemes;
 - examine whether equity derivative holdings are adequately covered by the current disclosure regime and whether there are any gaps in the law that permit certain investors to circumvent normal disclosure requirements;
 - determine what degree of influence or control is effectively transferred to the holders of equity derivative instruments;
 - determine whether a comprehensive disclosure framework can be consistently applied to over-the-counter (OTC) and exchange-traded equity derivatives;
 - determine whether disclosure should be made on the basis of economic rights, voting rights or the two together; and
 - examine the effectiveness of certain provisions in the *Corporations Act 2001* to adequately accommodate equity derivative holdings. The assessment will investigate the effectiveness not only of the substantial holding provisions (Part 6C.1), but also of the takeover provisions (Chapter 6), tracing notice provisions (Part 6C.2) and director disclosure provisions (section 205G) in this regard.

2.2 SCOPE

18. The assessment will broadly consider various aspects of Australia's current disclosure regime. The Government is particularly interested in the adequacy of current substantial holder notice requirements to capture relevant economic, control and voting interests in Australian listed companies and managed investment schemes.
19. The assessment aims to consider the disclosure requirements for positions held through equity derivatives only. Equity derivatives are broadly defined to include a range of financial instruments such as options, futures, forwards, contracts for difference (CFDs) and equity swaps. The specific forms of equity derivatives are

considered in more detail at paragraph 31, and include instruments that are both exchange-traded and OTC, and those that are cash-settled and delivery-settled.

20. The assessment is interested in disclosure of ownership, control and voting interests in listed companies and managed investment schemes. Consequently, it does not cover debt instruments or convertible notes. Similarly, this assessment is not concerned with derivatives referenced to indices, as it is only interested in derivatives that can be used to gain ownership or control of particular listed companies and managed investment schemes.
21. Finally, the assessment considers both long and short equity derivative positions. Long equity derivative positions lead to circumstances most closely related to controlling shares (such as profiting from increases in underlying share price, voting, and so on) and short equity derivative positions enable investors to maintain control over voting rights while reducing or eliminating their economic interest.

2.3 GUIDING PRINCIPLES

22. The Australian Government will undertake the assessment in accordance with the following guiding principles:

22.1. *Comprehensive regulatory framework*: any regulatory gaps, inconsistencies and weaknesses should be identified and addressed through a comprehensive examination. The resulting framework should ensure that investor conduct is properly overseen and that attempts to circumvent regulation are discouraged.

22.2. *Market integrity and investor protection*: the assessment and resulting regulatory outcomes should promote investor confidence and the integrity of Australia's financial markets. It is expected that an enhanced disclosure regime will achieve such an outcome. Particularly, the following outcomes would enhance the integrity of Australia's financial markets:

- *Better pricing signals*: greater disclosure should promote more informed pricing.
- *More informed buying and selling by investors*: informing investors of effective control allows better informed decisions and leads to greater confidence.
- *Better informed companies*: companies should be provided information about the effective control of the shares they issue on the market.

22.3. *Accommodate innovation*: the assessment should deliver a regulatory framework that keeps pace with innovation in financial instruments. Recognising that the market for equity derivative instruments continues to evolve, the Government does not intend for any disclosure framework to impede innovation. Rather, it should be flexible to accommodate the legitimate development of new financial products and to adequately reflect contemporary practice. Consequently, this assessment aims to ensure that current regulatory provisions adequately reflect contemporary practice.

22.4. *Balance of costs and benefits*: in developing a regulatory framework for derivative disclosure, the intended benefits of greater transparency should be weighed

against the costs of compliance. The Government does not wish to impose undue burdens on market participants or create unnecessary barriers to the flow of foreign investment to Australian markets.

- 22.5. *Coordinated policy responses*: the global nature of capital flows requires global responses. Fragmentation in global financial regulation is undesirable and the Government is committed to ensure that it moves and responds to global developments.

3 BACKGROUND

23. The current ownership disclosure framework was devised at a time when the calculation of ownership was relatively straightforward. Since then, significant growth in the use of equity derivatives challenges the ability of the current framework to adequately regulate disclosure. The Government acknowledges the extent of innovation that has occurred in Australian and overseas financial markets, particularly in the area of derivative instruments.
24. The Government is keen to enhance ownership disclosure regulation to ensure that it adequately takes account of the current use of equity derivatives. It also wants to close any gaps in the law that permit holders of equity derivatives to circumvent disclosure provisions normally associated with direct stakes. The aim is to ensure that Australia's financial markets are fully informed and that investors are protected.
25. In 2008, the Prime Minister called attention to this issue when addressing the Confederation of British Industry and Australian Business in London. He announced that Treasury would undertake an assessment of Australia's disclosure requirements for equity derivatives. The Prime Minister said that 'the lack of an appropriate disclosure framework covering equity derivatives has:
 - reduced transparency of ownership changes and takeover moves;
 - reduced the ability of companies to know who their effective owners are; and
 - enabled hedge funds to outflank traditional institutional investors by using economic interests to influence companies'.¹

3.1 WHAT ARE EQUITY DERIVATIVES?

26. Equity derivatives, like other derivative instruments, are financial contracts whose value is derived from underlying assets, in this case shares in companies or managed investment schemes or in share indices. Equity derivative instruments are commonly used to manage risks associated with share trading and ownership and are also commonly used in speculative trading strategies.
27. Equity derivative instruments take various forms, some of which are discussed below. Generally, however, they involve two counterparties:
 - 27.1. *Taker or holder*: usually the client, the taker of an equity derivative purchases the equity derivative contract from the issuer or writer.
 - 27.2. *Writer or issuer*: usually an investment bank or other financial institution, the writer of a derivative contract issues or sells the contract to the taker or buyer.

¹ 'Australia's Economic Future', speech to Confederation of British Industry and Australian Business, London, 4 April 2008.

3.2 TYPES OF EQUITY DERIVATIVE INSTRUMENTS

28. A broad range of equity derivative instruments are available for trade in Australian and overseas markets. The Government acknowledges this diversity in form and intends a comprehensive disclosure framework to address the common features of these instruments without leaving regulatory gaps.
29. Equity derivatives can be settled either in kind, that is through an exchange of the referenced shares, or in cash. Cash-settled equity derivatives involve the exchange of cash only and there is no requirement to exchange the referenced shares, although in practice such an outcome may eventuate. The nature of contract delivery potentially has important implications for disclosure.
30. Equity derivatives can take either a long or a short position in the referenced shares or index.
31. Below is a non-exhaustive list of common equity derivative instruments. The assessment will consider all these instruments for inclusion under a comprehensive disclosure regime.
 - 31.1. *Options*: an option contract gives the taker the right, but not the obligation, to buy or sell a referenced quantity of shares or index value in the future at a particular price. Options are the most common form of equity derivative and can be traded on the Australian Securities Exchange (ASX). Options can reference either issued shares or shares that are yet to be issued. Options over unissued shares (that is, options issued by the company over shares yet to be issued) limit the extent of potential non-disclosure to the number of unissued shares.
 - 31.2. *Futures*: a futures contract is the obligation on the taker to buy or sell a referenced quantity of shares or index value in the future at a particular strike price. Futures are standardised contracts that trade only on the Sydney Futures Exchange (SFE) and holders are subject to margin calls depending on the underlying movement in the value of their contracts. Although futures technically settle by delivery of the underlying asset, this is rare as most investors close their positions by taking an equal but opposite contract. Due to insufficient volumes traded, equity futures no longer trade on the SFE, although index futures are still traded.
 - 31.3. *Equity swaps/CFDs*: also known in some jurisdictions as contracts for difference (CFDs), equity swaps involve two parties agreeing that one party (the swap provider) will pay the rate of return on an equity referenced asset in exchange for a fee payable by the other party (the swap taker). The swap taker also compensates the swap provider for any fall in value of the referenced share over the life of the swap. Swaps typically involve the exchange of the cash difference between the total equity return and the fee accrued over the period, and usually the referenced share portfolio does not change hands. These instruments have increased in popularity because of the benefits of leverage, stamp duty savings and access to economic benefits without having to directly own the referenced shares.
 - 31.4. *Warrants*: a warrant is a derivative instrument issued by banks to provide investors with leveraged exposure to the underlying shares. Investors holding warrants are generally entitled to dividend income and franking credits. In Australia, warrants are traded on the ASX. Australian Securities and Investments

Commission (ASIC) Regulatory Guide 143 regards that in the context of takeovers, warrant holders have a relevant interest in underlying shares and should disclose.²

32. *Index-linked derivatives:* options, futures, swaps, CFDs, and so on, can also be referenced to a stock market index, rather than a particular share. This assessment does not consider these instruments as they do not give significant influence or control over a particular company.
33. *Convertible notes:* Convertible notes are debt instruments that give the holder the option to convert the note into equity in the future at a pre-determined rate. Although convertible notes' value is partially derived from the referenced share, this assessment is not concerned with debt securities and considers convertible notes outside of its scope.

Questions

- i. *Does the list of equity derivative instruments covered provide adequate scope for this assessment to determine the effectiveness of the current regulatory regime?*
- ii. *Should the assessment investigate particular equity derivative instruments or should equity derivatives be broadly defined?*

3.3 TRADING PLATFORM

34. Equity derivatives are traded either on an organised exchange or on the over-the-counter (OTC) market. In Australia, exchange-traded equity derivatives including options, CFDs and futures (index only) are traded through the ASX.
35. Data about investor identity and transaction volumes and size can more easily be obtained by the operator of the organised exchange and as a result, compliance with disclosure provisions can easily be monitored. The OTC market is not as readily observable as its exchange counterpart.
36. The Government wishes to determine whether a comprehensive disclosure framework can be consistently applied across the two trading platforms. The Government acknowledges that investors choose to trade through an exchange or the OTC market for their respective trading features and does not wish to interfere in this aspect of derivative trading.

² ASIC, *Regulatory Guide 143: Takeovers provisions: Warrants*, 4 August 1999.

Questions

- iii. *What are the practical differences in disclosing positions in OTC contracts and exchange-traded contracts?*
- iv. *Should exchange-traded contracts, OTC contracts or both types be considered? Please explain.*

3.4 USAGE

37. Equity derivative instruments have increased in popularity in risk management and speculative trading in recent years. Consequently, trading volumes in both exchange-traded and OTC equity derivative contracts have grown significantly.
38. This growth in equity derivative trading raises the importance of introducing a comprehensive regulatory framework for adequate and timely disclosure.
39. Volumes in exchange-traded derivative contracts on the ASX have risen in recent years, although option volumes fell during 2008. Contract volumes in exchange-traded options rose by a compound annual rate of 6.1 per cent between 1999 and 2008. Equity CFDs, which commenced trading on the ASX in November 2007, trade at an average monthly volume of 6.3 million contracts.³ See Figures 1 and 2 for popular ASX-traded equity derivative trading volumes.

³ ASX Market Data, www.asx.com.au, March 2009.

Figure 1: ASX Equity CFD Volumes
Million contracts

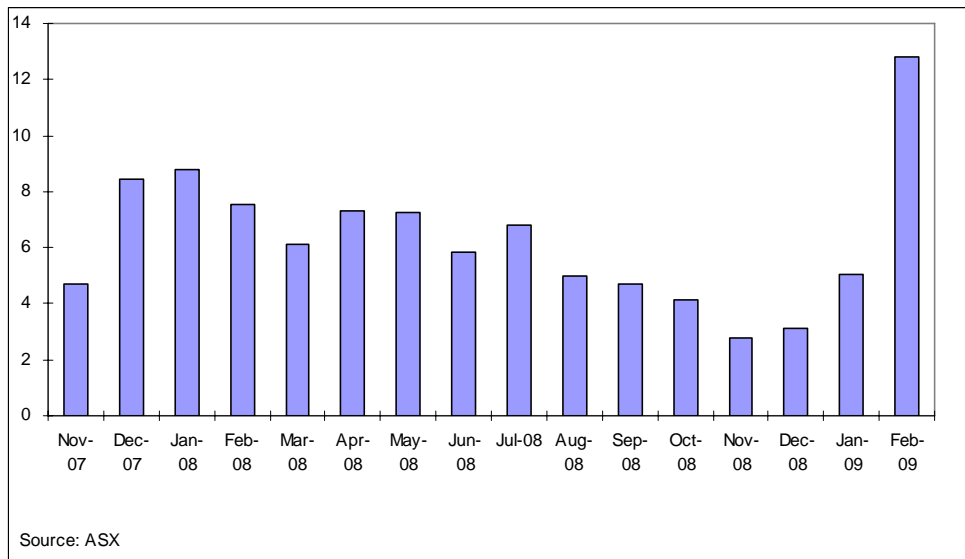
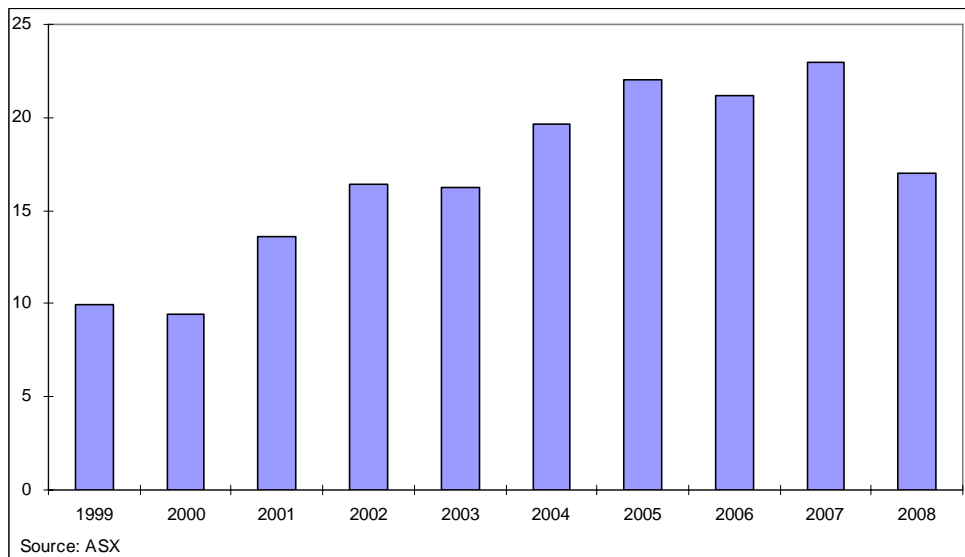


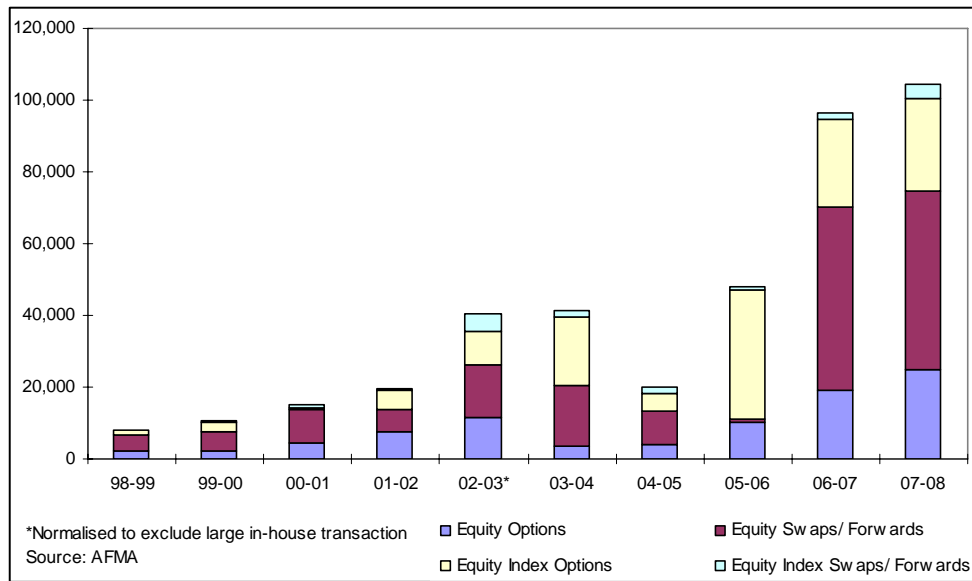
Figure 2: ASX Exchange-Traded Options Volumes
Million contracts



40. As in other overseas markets, volumes in the OTC market have grown significantly. Survey data compiled by the Australian Financial Markets Association (AFMA) indicate that total OTC equity derivative turnover increased by a compound annual rate of 32.7 per cent between 1999 and 2008. Turnover in the OTC market reached \$104.6 billion during fiscal year 2008 and equity swaps and forwards accounted for 47.5 per cent of this figure.⁴ See Figure 3 for AFMA survey data of OTC trading in Australia.

⁴ AFMA, *Australian Financial Markets Report*, all issues from 2001 to 2008.

Figure 3: Australian OTC Equity Derivatives Turnover
A\$ million



Questions

- v. Treasury is interested in further data and would welcome additional information about the usage, purpose and types of equity derivatives in practice.
- vi. Treasury is interested in common forms of cash-settled equity derivatives such as equity swaps and CFDs.
- : How commonly are these instruments used?
 - : When are they most likely to be used?
 - : Why is their use more prevalent now?

3.5 HISTORICAL CONTEXT

41. The Government acknowledges the need for effective financial market regulation as highlighted by G20 discussions. The Government considers effective regulation of major importance to the fairness and transparency of Australian financial markets and to the broader economy.
42. Recent domestic and overseas developments involving equity derivatives have alerted the Government to the potential need for an enhanced disclosure regime that adequately captures the transfer of economic interests, control and voting rights through derivative contracts. Although the *Corporations Act 2001* forms an adequate disclosure regime for direct share and voting interests, recent events demonstrate the potential for investors to circumvent normal disclosure provisions through the use of equity derivative instruments.
43. A non-exhaustive list of recent Australian and overseas regulatory and policy developments are summarised below:

- *April 2005*: in Australia, Glencore International Limited AG discloses an 11.4 per cent interest in Austral Coal Limited, a takeover target of Centennial Coal Limited, including a 6.5 per cent indirect interest held through cash-settled equity swaps. The previously undisclosed interest prevents Centennial’s compulsory acquisition of Austral. The Takeovers Panel declares Glencore’s untimely disclosure to be unacceptable circumstances.
- *March 2006*: the UK Financial Services Authority (FSA) acknowledges calls for greater disclosure of effective voting interests held through contracts for difference.⁵
- *November 2007*: the FSA issues its consultation paper and draft rules for disclosure of CFDs. The FSA finds mixed evidence of market inefficiency resulting from non-disclosure of economic interests held through CFDs but proposes options for an enhanced ownership disclosure regime.⁶
- *April 2008*: the Australian Prime Minister announces that Treasury will review appropriate disclosure requirements for equity derivatives.
- *April 2008*: following a consultation process, the Australian Takeovers Panel issues *Guidance Note 20: Equity Derivatives*, stating that the Panel considers that non-disclosure of long positions in derivatives may give rise to unacceptable circumstances, in particular non-disclosure of long positions held in a company greater than 5 per cent should be disclosed where there is a control transaction.⁷
- *June 2008*: the US Court for the Southern District of New York rules that two hedge funds, The Children’s Investment Fund and 3G Capital Partners, which were both involved in a proxy contest with CSX Corporation, had violated disclosure requirements of the US Securities Exchange Act of 1934 by using cash-settled total return equity swaps to avoid disclosure requirements and that they should be deemed beneficial owners of CSX shares held by swap counterparties as hedges.
 - : District Judge Kaplan said, ‘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.’⁸
- *July 2008*: in Germany, conglomerate Schaeffler announces that it has secured 36 per cent of takeover target Continental AG, including 28 per cent through cash-settled equity swaps. The German Federal Financial Supervisory Authority (BaFin)

⁵ FSA, *CP06/04: Implementation of the Transparency Directive and Investment Entities*, http://www.fsa.gov.uk/pubs/cp/cp06_04.pdf, March 2006.

⁶ FSA, *CP07/20: Disclosure of Contracts for Difference – Consultation and Draft Handbook Text*, http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf, November 2007.

⁷ Takeovers Panel, *Guidance Note 20: Equity Derivatives*, http://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=guidance_notes/current/020.htm&pageID=&Year=, April 2008.

⁸ *CSX Corporation v The Children’s Investment Fund Management (UK) LLP, et al.*, United States District Court Southern District Of New York, 11 June 2008.

subsequently finds no breach of disclosure obligations by Schaeffler because the swap arrangements did not involve a transfer of voting rights.⁹

- *October 2008*: also in Germany, corporate bidder Porsche announces that it effectively controls 74.1 per cent of Volkswagen shares, 31.6 per cent of which were referenced by cash-settled equity swaps. Following the announcement, shares in Volkswagen jump 350 per cent over two trading days to €945 before falling to about €400 over the next few trading days.
- *March 2009*: the FSA publishes its final policy statement on CFDs. Briefly, the new rules state that shares referenced by CFD holdings will be aggregated with direct share holdings when calculating total interest under a general disclosure regime.¹⁰
- *June 2009*: new FSA disclosure regime for contracts for difference to take effect. Implementation has been brought forward from September 2009.

44. While Australia has been home to a limited number of high-profile events involving equity derivatives, emerging trends in the usage of these instruments could challenge the effectiveness of existing regulatory frameworks. This assessment aims to explore options to strengthen the current disclosure regime.

Questions

- vii. *To what extent are equity derivative instruments used to avoid ownership disclosure requirements in practice?*
- viii. *Has this resulted in the market being inadequately informed? If so, please explain in what way.*

⁹ BaFin, *No breach of reporting requirements identified in Continental AG takeover procedure*, http://www.bafin.de/clin_116/nn_720494/SharedDocs/Mitteilungen/EN/2008/pm__080821__conti.html?__nnn=true, 21 August 2008.

¹⁰ FSA, *PS09/3: Disclosure of Contracts for Difference - Feedback on CP08/17 and Final Rules*, http://www.fsa.gov.uk/pubs/policy/ps09_03.pdf, March 2009.

4 DISCLOSING SUBSTANTIAL HOLDINGS

45. This assessment is examining whether equity derivative holdings are adequately covered by the current disclosure regime. At present, the definition of substantial holdings in the *Corporations Act 2001* determines whether disclosure of a derivative position is required.
46. Two features of derivative holdings appear to exclude them from the current definition of a substantial holding:
 - cash settlement; and
 - grant of economic interests but not voting rights
47. This assessment aims to determine whether, given these features, equity derivatives should be included in the definition of substantial holding in section 9 and Chapter 6C of the *Corporations Act 2001* and, if so, on what basis they should be included.

4.1 CASH SETTLEMENT AND SUBSTANTIAL HOLDING PROVISIONS

48. Equity derivatives can be settled either in kind, that is through a transfer of the referenced shares, or in cash. Cash-settled equity derivatives involve the exchange of cash only and there is no requirement to exchange the referenced shares. It is common practice for the issuer of the contract to hold shares as a hedge to manage risk, but this is not explicitly required by the contract.
49. Cash-settled equity derivatives potentially represent an important challenge to the current disclosure framework.
 - Investors with substantial holdings in listed companies and managed investment schemes must disclose their interests. A ‘substantial holding’, as defined by section 9 of the *Corporations Act 2001*, is a relevant interest in at least five per cent of the total number of votes in a company. Investors must therefore determine whether they have a substantial holding based on the number of votes that they control. When investors hold substantial parcels of shares directly, their obligations clearly require them to disclose.
 - When investors hold cash-settled derivatives, however, their disclosure obligations are less clear. When a derivative contract does not require shares to change hands at maturity, there is technically no change of direct ownership or voting rights. Neither party to the derivative contract is legally required to take a physical interest in the referenced shares and neither necessarily gains voting rights in the company. On this basis, generally there appears to be no requirement to disclose such equity derivative positions under the existing law, although specific terms of the equity derivative or side agreements between the issuer and the holder may lead to a different conclusion.
50. Practical considerations, however, may mean that the derivative holder has real, effective control over the underlying shares.
 - In the case of a long equity derivative contract, the issuer may hedge its risk by taking a physical interest in the referenced shares. There is nothing preventing the

issuer from eventually selling this parcel directly to the holder of the contract at maturity. Indeed, there may be an expectation that it will do so if called upon by the holder.

- The fact that the issuer buys the referenced shares, so that they are removed from the market, may have significant effects on the market even if the shares are not eventually sold to the holder. For example, they may prevent a takeover bid from reaching a critical level of acceptance.
- The derivative holder may influence the issuer in the exercise of voting rights attached to those shares.
- If in such circumstances the total parcel of hedged shares is substantial, non-disclosure by the derivative holder potentially can challenge the fairness and transparency of the market in which the shares trade. Failing to inform the market of the derivative may deny the market information which is relevant to the price and to the decisions of other investors.

51. Ostensibly, it appears that hedging of shares can carry information content. In the previously mentioned US case of *CSX v The Children's Investment Fund (2008)*, the court stated that the holding of shares for hedging by the issuer of cash-settled equity swaps does constitute information content which the market would find relevant. The court stated that hedging can alter corporate voting by:

- 'eliminating the shares constituting the hedge positions from the universe of available votes;
- subjecting the voting of the shares to the control or influence of a long party that does not own the shares; or
- leaving the vote to be determined by an institution that has no economic interest in the fortunes of the issuer, holds nothing more than a formal interest, but is aware that future swap business from a particular client may depend upon voting in the "right" way'.¹¹

52. One of the issues that this assessment is seeking to determine is the degree to which ownership benefits, such as voting rights, are effectively transferred under cash-settled equity derivative contracts. The assessment also aims to determine whether equity derivatives give investors effective control to such a degree that the market has a legitimate interest in seeing such derivative positions disclosed.

4.2 SEPARATION OF ECONOMIC INTERESTS FROM VOTING RIGHTS

53. Equity derivatives allow voting rights and the economic benefits of holding shares to be separated.

- In a long equity derivative contract, the holder of the contract in effect assumes the same economic risks and benefits as if it owned the shares. The issuer will likely hedge its position by buying shares to hedge its obligation in the contract. This direct interest in the shares entitles the contract issuer to voting rights but the

¹¹ CSX Corporation v The Children's Investment Fund Management (UK) LLP, et al.

derivative effectively transfers the economic interest to the holder, who bears the economic consequences of price movements in the underlying shares.

- In a short equity derivative contract, the holder adopts the reverse position, as it benefits from any decrease in the share price and must pay for any returns on the shares. It is possible for the holder to already hold a direct interest in the shares, which entitle it to the attached voting rights. The economic interest, however, passes to the issuer, who bears the economic consequences of price movements in the underlying shares. The short equity derivative has the effect of neutralising the holder's normal economic interest in the shares.
54. The ability to separate economic interests from the voting rights attached to shares in this way has potential implications for disclosure of effective interests held through either long or short equity derivative positions.
- Under a long equity derivative contract, it is unlikely that either the issuer or the holder will disclose their positions. The holder of the derivative contract does not take a direct interest in the shares and therefore does not directly acquire voting rights. Consequently, the holder is not obliged to disclose its position, in spite of its effective economic interest. The issuer, on the other hand, must disclose any substantial direct holdings in shares it holds as a hedge. In practice, however, the parties to a derivative could limit the size of the contract to a non-substantial holding, so that the holder would enter into a series of similar contracts with other issuers.
 - Under a short equity derivative contract, disclosure is also unlikely. The issuer will have no requirement to disclose its effective economic interest because it does not have control over the voting rights attached to the referenced shares. If the holder holds a direct substantial stake in the shares, it would have already disclosed this position as part of ordinary disclosure obligations. It would not, however, have to disclose the fact that it has effectively transferred its economic interest to the issuer.
55. The separation of voting from economic interests in a company may lead to situations in which investors with no beneficial interests in the firm are able to vote or in which investors with no voting rights are exposed to the economic outcomes of ownership. It may also lead to the market making mistaken assumptions that a person who has disclosed they hold shares and voting rights also holds an economic interest in those shares.
56. While the separation of ownership rights is not itself necessarily a concern, the assessment raises the issue of whether these derivative arrangements should be disclosed and whether any such disclosure should be made on the basis of economic rights, voting rights or the two together.
- For reasons outlined above and in Section 4.1, it appears that a long derivative contract may give the derivative holder some real, effective control over the underlying shares and an underlying economic interest in them.
 - Conversely, a short derivative position may lead to a situation referred to as 'empty voting', where an investor is able to exercise voting rights despite holding a reduced or zero effective economic interest in a company. This may mislead the market about the holder's real economic stake in the company.

57. Failing to inform the market of substantial derivative contracts that alter the effective economic interest in a firm may deny the market information which is relevant to the price and to the decisions of other investors. This assessment seeks to determine whether disclosure should be required and if so, whether it should be made on the basis of an effective economic interest in addition to voting interests.
58. Not every economic interest in a company must be disclosed. Disclosure has traditionally been required only where an interest may affect control of the company. It may not be appropriate that disclosure be required of every significant short derivative position.
59. There might be a stronger case for requiring disclosure of a short derivative position where disclosure is already required in relation to a relevant long interest. In such a case that existing disclosure could arguably be misleading unless the short derivative position is also disclosed, to make it clear that there is no matching economic interest.

Questions

- ix. *Do substantial cash-settled equity derivatives transfer significant effective control over shares? If so, how?*
- x. *Have you seen instances of market failure as a result of non-disclosure resulting from the holding of equity derivatives? Where possible, please provide details of the case.*
- xi. *Can equity derivatives give certain investors undue advantage in gaining interests in companies without having to disclose these interests? What are these advantages?*
- xii. *It appears that issuers of equity derivative contracts typically hedge their positions by acquiring the referenced shares. In practice, are there instances in which this does not happen? Is this typically required by the contract or by internal risk protocols?*
- xiii. *If there is physical hedging by the counterparty, how common is it for the taker to be aware of this hedging?*
- xiv. *In practice, do counterparties in equity derivative contracts typically issue voting instructions to the direct holder of the referenced shares, or seek to influence voting in any way?*
- xv. *It appears that cash-settled equity derivatives present the main challenge to the current ownership disclosure framework. Do the features of delivery-settled contracts also present similar or other problems for disclosure? If so, how?*
- xvi. *The existing ownership disclosure regime requires disclosure of voting interests in shares. Would disclosure of short derivative positions have any benefit to market transparency? Would it be desirable only where an offsetting long equity or long derivative position has been disclosed? What are the advantages of disclosure of short equity derivative positions?*
- xvii. *How common is 'empty voting'? Does this practice undermine the fairness and transparency of the market?*

5 OTHER DISCLOSURE REQUIREMENTS

60. In the context of disclosure more broadly, a range of other issues arise. The Government seeks disclosure and transparency which is of a practical benefit. The following sections consider other provisions in the *Corporations Act 2001* whose effectiveness may be challenged in the context of non-disclosure of equity derivatives.

5.1 TAKEOVER PROVISIONS

61. Takeovers and the market for corporate control is an area in which disclosure of control and voting interests can potentially have significant effects on the transparency and order of the market. The integrity of the takeover provisions in the *Corporations Act 2001* rests in part on adequate disclosure relevant interests.
62. The takeover provisions in the *Corporations Act 2001* place restrictions on the accumulation of direct holdings above 20 per cent of total shares issued. If an investor wants to acquire more than 20 per cent, they must either launch a takeover bid or bring themselves within one of the statutory exceptions.
63. These provisions, however, apply only to direct stakes and not to equity derivative holdings. The potential exists, therefore, for investors to use equity derivatives to acquire interests in listed companies and managed investment schemes of greater than 20 per cent without the same restrictions associated with direct stakes.
64. If the requirements for substantial holder notices are amended to incorporate equity derivative positions, it is arguable that this apparent gap in the takeover legislation may not be an issue because the market can be relied on to price in a control premium, thereby rewarding other shareholders with the premium that an acquirer of direct stakes normally has to offer in a takeover bid. Arguably, the Takeovers Panel could address such an issue when it arises in practice.
65. This assessment seeks to determine whether this possible regulatory gap is a significant problem and whether it needs to be addressed within the scope of this assessment.

Question

- xviii. *If substantial holder notice provisions were to be expanded to include equity derivative positions, would there still be a regulatory gap that allows equity derivative holders to circumvent takeover provisions?*
- xix. *Would such a gap be a problem in practice?*
- xx. *To what extent could the market be relied on to price in a control premium, thereby sufficiently rewarding shareholders with the premium that an acquirer of direct stakes normally has to offer in a takeover bid?*
- xxi. *Would there be scope for the Takeovers Panel to address these issues when they arise in practice?*
- xxii. *If substantial holder notice provisions were expanded to include equity derivative positions, should the law be amended so that positions over 20 per cent must also comply with the takeover provisions? Should the assessment consider whether the takeover provisions in the Corporations Act 2001 would benefit from an expansion to include equity derivatives holdings?*

5.2 TRACING NOTICE PROVISIONS

- 66. Tracing notice provisions also deal with disclosure obligations for holders.
- 67. Part 6C.2 of the *Corporations Act 2001* allows the Australian Securities and Investments Commission (ASIC) or companies to send tracing notices to holders of those companies to collect beneficial holding information. Provisions governing tracing notices aim to promote the timely disclosure and transparency of ownership information.
- 68. Current rules require investors to disclose any relevant interests in a listed company. The definition of relevant interest, however, does not appear to include equity derivative interests. The potential therefore exists for ASIC or companies that issue tracing notices to fail to detect their 'effective owners' who have an interest in the referenced shares through a derivative.

Questions

- xxiii. *Do companies that issue shares on the market require information about equity derivative contracts that reference substantial parcels of their shares?*
- xxiv. *Should the assessment consider extending the tracing notice provisions to include equity derivatives?*

5.3 DIRECTOR DISCLOSURE PROVISIONS

- 69. Section 205G of the *Corporations Act 2001* requires directors of listed companies and managed investment schemes to disclose their relevant interests in the entities they manage.

70. It appears that current rules do not require director disclosure of equity derivative positions referenced to the company's shares. In other words, directors could acquire or dispose of their interests through the use of equity derivatives. In the context of existing disclosure requirements for directors' shareholdings, which inform investors about the interests of board and company management, it would appear that current rules permit a gap in the law.
71. The Government acknowledges that information about directors' buying and selling activities in their companies is important for transparency. Although the scope of this assessment is limited to disclosure of long-only equity derivatives, there may be a case for requiring the disclosure of short equity derivatives as well. It appears that under current rules, directors can effectively reduce their holdings through the use of short equity derivatives without being required to disclose those derivative positions.

Questions

- xxv. *Are you aware of instances of directors covertly accumulating or disposing of interests in companies through the use of equity derivatives?*
- xxvi. *Should the assessment consider expanding the relevant legislation to incorporate equity derivative holdings in director disclosure provisions?*
- xxvii. *The scope of this assessment excludes short equity derivatives. However, should an examination of expanding director disclosure provisions to provide investors with information about any director holdings of short equity derivatives be considered? What risks might this pose?*