Unidroit Conference

The Law of Securities Trading in Emerging Markets

Mandatory and contract-based ownership disclosure

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Outline

1. Ownership Disclosure (OD)
2. Shareholder Identification (SI)
3. OD and SI: pros and cons
4. OD and SI effects on control contestability
5. Implications for policymaking

Ownership disclosure

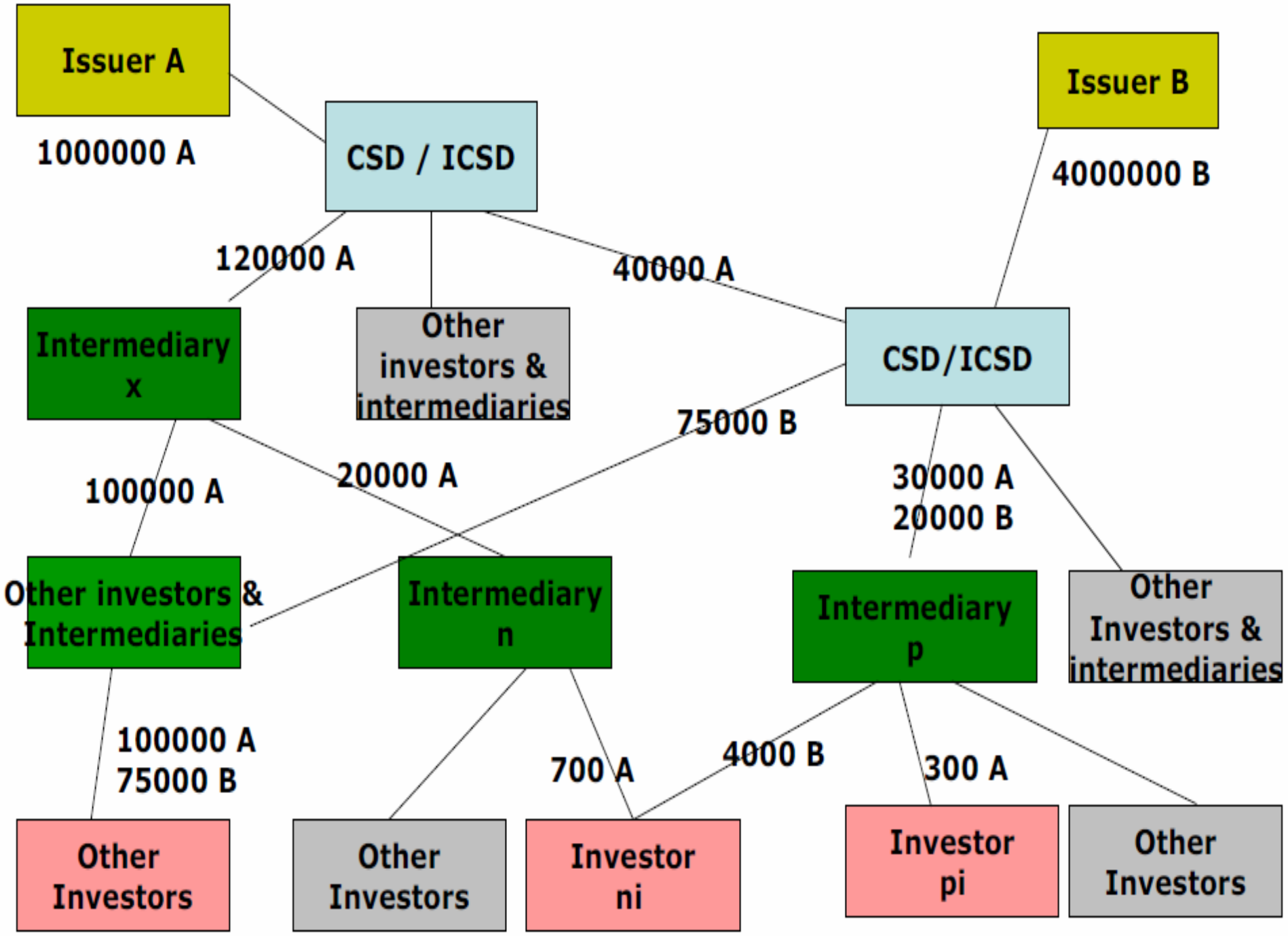
- All major jurisdictions require major shareholders of listed companies to disclose their holdings to the extent that they exceed some relevant thresholds
- The underlying rationale (according to common understanding) is that dissemination of major holdings (and their changes):
  - provides valuable information on voting structure
  - increases transparency on capital movements (may help police unfair trading practices)

Ownership disclosure (2)

- OD is generally triggered when shareholdings reach, exceed or fall below certain thresholds
- In the EU, Directive 2004/109/CE (Transparency Directive) sets the following thresholds:
  - Initial threshold: 5%
  - Subsequent thresholds: 10%, 15%. 20%, 25%, 30%, 50%, 75%
- Member States may however fix additional thresholds (e.g. Germany and UK: 3%)
- As for non-EU countries, US and China: 5%; CH: 3%

Shareholder Identification

- For a number of reasons, issuers in many countries have no access to their shareholders' identity:
  - Bearer shares
  - And registered shares, too: shareholders are hidden behind (often: long and complex) holding chains – see the Unidroit Convention on "intermediated securities"
    - Where the distinction between legal and beneficial ownership applies, normally only legal owners are "members"
    - In other countries, members' register is not regularly updated, so that companies ignore who their shareholders are
- Of course, whenever rules are in place requiring OD, SI is only relevant for shareholder "below the


Issuer A
1000000 A
CSD / ICSD
Issuer B
4000000 B
120000 A
40000 A
Intermediary x
Other investors & intermediaries
CSD/ICSD
75000 B
100000 A
20000 A
30000 A
20000 B
Other investors & Intermediaries
Intermediary n
Intermediary p
Other Investors & intermediaries
100000 A
75000 B
700 A
4000 B
300 A
Other Investors
Other Investors
Investor ni
Investor pi
Other Investors

Shareholder Identification (2)

US:
- Regist. shares, distinction btw legal/beneficial own.
- DTC (the Central Securities Depository – CSD) appears as a shareholder holding most of outstanding capital
- SI mechanisms are in place in order to find out who actually the shareholders are at the end of the chains. Shareholder may object ("NOBO/OBO – (non-)objecting beneficial owner – system")
- SI mainly takes place before AGMs (shareholders receive proxy material): a "search card" is sent to broker/dealers and banks appearing on DTC list
- Quest for shareholders continues till the end of the chain is reached

Shareholder Identification (3)

UK: • Regist. shares, distinction btw legal/beneficial own.

• CSD members appear as shareholders on members' register held by issuers or registrars

• Issuers may send a "Sec. 793 notice" to any person (including members and other nominees) having an "interest in share"

• SI often takes place on a regular basis (intermediaries complain they are "routinely bombarded")

• Quest for shareholders continues till the end of the chain is reached

Shareholder Identification (4)

D: • Registered and bearer shares (at the company's option)

- For registered shares, final accountholder usually registered as "shareholder"
- However, absent a regular update, intermediaries are sometimes registered as shareholders in order to fill the gaps in the members' register ("placeholders")
- Companies may send a request to registered persons in order to investigate who the actual shareholders are (§ 67 AktG)
- No such mechanism is in place for bearer shares

Shareholder Identification (5)

F: • Registered and bearer shares (individual sh. chooses)

- Registered shares may be held as either “intermediated securities” or “non intermediated securities”
  - non intermediated securities ensure a direct relationship btw issuer and its shareholders
  - for intermediated securities, Euroclear ensures a daily update of members’ register thanks to specific massages from French intermediaries (Bordereau de Reference Nominative, “BRN”)
- Only foreign intermediaries may appear as “shareholders” on members’ register
- Specific inquiries may address bearer shares (if the bylaws so provide). If this is the case, bearer shares are called “Titre au Porteur Identifiable – TPI”

OD: pros

Better corporate governance:

Clear, updated picture of block-holders' identity (including final beneficial owners):

- allows to understand who has or may have an influence over management:
  - i.e., facilitates market monitoring of block-holders' use and abuse of control power
- allows investors to understand the degree of control contestability and the nature of controlling shareholders and blockholders more generally (e.g having a private equity fund as controlling shareholder is not the same as having a family in the same position)

OD: cons

It may reduce market efficiency

- OD reduces **investors' incentives** to incur in cost of searching information and to engage in activist strategies
  - many institutions choose to keep their holdings just below the threshold in order to avoid:
    - compliance costs of:
      - One-off adaptation (cross-time and cross-country);
      - Ongoing monitoring and filing;
    - liability/public enforcement risk (crucially depending on scope of disclosure)

OD: cons (2)

- Ownership disclosure raises the legal risk of institutions' coordination for activism purposes (especially if "acting in concert" is defined too broadly or ambiguously)
- information is noisy itself, because of thresholds for initial and subsequent variations

SI: pros

Better corporate governance:

Identification of shareholders other than block-holders (including final accountholders):

- facilitates issuers' contacts with investors (investor relations)
  - Developing stable relationship with investors makes them more willing to participate in right issues
  - Greater GM participation
- facilitates coordination among shareholders (to the extent that information on shareholders' identity is made available to the public – e.g. UK – or to other shareholders – e.g. Italy –, which is not always the case – e.g. Germany)

It may help monitoring insider trading

SI: cons

Trading strategies and/or intentions of investors “below the line”, which may have a legitimate interest to stay in the dark, may be discovered by shareholder identification mechanisms:

- a number of tools commonly used to conceal ownership (e.g. trust) may be overcome by shareholder identification (eg. UK Companies Act Sec. 793 is understood as imposing a disclosure of the beneficial owner’s identity)

- other devices that can be made recourse to (e.g.: split btw companies under common control) are costly

OD and SI: pros

- Key shareholders' trading activities convey valuable information to the market (signaling)
  - thus, disclosure of all trading activities by significant block-holders might be the most effective solution
  - may help policing insider trading practices, too

OD and SI: cons

- Communication of all ownership variations to the market is costly
- [Institutional] investors have a legitimate interest in protecting their equity research activity and trading strategies

OD and SI: control contestability

Information on stake-building is an early warning for managers and incumbent blockholders

- OD and SI reduce potential bidders' incentives (by forcing an early declaration or discovery of intentions, they make acquisitions costlier)

Should the law set the "right" level of control contestability?

Takeovers have both positive and negative effects:

- Discipline device for managers
  - But reduced incentives to make firm-specific human capital investments by managers and monitoring by blockholders
- Reallocate control
  - But market for corporate control is not perfect (e.g. pressure to tender, free riding, private benefits of control)

A “neutral” approach to takeover is therefore desirable

- The law should in principle neither facilitate nor hamper takeovers: issuers are in a better position to evaluate whether pros prevail over cons
- Since incumbents (controlling shareholders or strong managers) are in a better position to push towards lower contestability, default rules should be devised that tilt on the side of more contestability
- Some key features of regulations in this area will mainly depend on how hostile States – and supra-national policymakers – are to hostile takeovers

Implications for policymaking

- Because there are costs as well as benefits, then a balanced approach is needed:
  - Too much OD is no better than too little; a too pervasive SI system can bring more costs than benefits
- OD's and SI's effect on the market for corporate control is negative:
  - Some scope should be left to issuers' discretion with appropriate optional choices
- National/issuers discretion could be limited to a few transparent choices *(see below)*

What scope for the law? (OD)

- A neutral approach requires:
  - Delayed disclosure for perspective bidders (with opt-out by issuers)
  - Because what counts is influence over management, the initial triggering threshold should be fairly high (*especially if derivatives are aggregated*) (a 10 percent threshold may be a viable solution)
  - option for issuers to set either a lower (or even a higher) threshold

What scope for the law? (OD) (2)

Mandatory (and detailed) legislation may make sense, on the contrary, on technicalities:

- Definition of "holding" and "interest in shares" (e.g. Sec. 793 UK Companies Act 2006), including treatment of stock lending and of derivatives, acting in concert, filing forms, timing and means of dissemination, exemptions, etc.

- [Supranational harmonization on such issues can further capital markets integration by reducing transaction and compliance costs: these are areas in which, to some degree, standardization trumps substance]

What scope for the law? (OD) (3)

But there are also issues for which the rules' content is much more sensitive and relevant, while the need for uniformity (both at State and supranational level) is weaker due to lower adaptation costs.

- Initial threshold (substantial and imposing low adaptation costs)
  - Here, issuers' discretion should combine with adequate dissemination on States' and issuers' choices
- Declaration of intentions is another area where an optional, either-or approach could be justified
  - Its antitakeover effect is self-evident, and it is therefore wiser to leave this delicate matter for issuers to decide
  - A declaration of intentions can be very costly in terms of liability/public enforcement risk (hard to tell whether one lies)

What scope for the law? (SI)

- In jurisdictions where SI mechanisms have been recently introduced, many issuers used to complain about their inability to know who their shareholders were
- Couldn't they solve the problem by amending their bylaws? I.e.: is legislation needed at all?
  - Bylaws could require shareholders to communicate information regarding their identity and their shareholding
  - Appropriate sanctions could be set in order to enforce SI
    - Disenfranchisement
    - Exclusion from dividend distribution

What scope for the law? (SI) (2)

Without legislation:

- SI would require cooperation by intermediaries in order to (i) seek ultimate accountholder consent and (ii) retrieve data on ultimate accountholders' identity and ownership
- Again, identification of intermediaries that compose the holding chain may be impossible without the cooperation of other intermediaries and the CSD
- Therefore, issuers should bargain with the CSD and each intermediary within the chain in order to reach the final intermediaries; then, they should bargain with every final intermediary in order for the latter to ask shareholder's agreement: this may prove prohibitively costly

What scope for the law? (SI) (3)

- In sum, transaction costs show that there is room for legislation in this field (provided that SI has pros):
  - Legislation would in fact impose intermediaries an obligation to cooperate with issuers

- How should such legislation look like?

What scope for the law? (SI) (4)

- A neutral approach requires issuers' discretion as to whether an SI mechanism should be (i) provided for and (ii) triggered
- Whether where members' register is not updated on an ongoing basis (e.g. D) or where the holding chain separates legal ownership from beneficial ownership (e.g. UK), the mechanism would better be enshrined in the company's statute (as is the case, for bearer shares, in F but not in D and the UK)
- Legislation should always let issuers opt-out or, preferably, require that issuers opt-in, via bylaws

Wrapping up

- Disclosure vs. property rights in information
- National vs. supranational?
- Mandatory vs. default?
- Contestability vs. entrenchment, i.e.
- Pro or against takeover?
  - Neutral!