

New transparency regime for cash-settled derivatives

*For some years now, regulators in Italy and at the European level have focused on the need for greater transparency for holdings of cash-settled derivative instruments, mainly because these instruments may be used with an intent to elude the law. While debate continues in Brussels, CONSOB has taken action (following in the footsteps of the United Kingdom, France and, most recently, Germany) to impose a new transparency regime upon holdings of financial instruments which have as their underlying the shares of listed companies, and which provide for settlement in cash, by way of amendment of CONSOB Regulation 11971 of 14 May 1999 (the "**Regulation on Issuers**").*

*The new provisions of law will become effective 30 days after Consob resolution No. 17919 ("**Resolution 17919**"), which amends the Regulation on Issuers, is published in the Gazzetta Ufficiale.*

Regulatory changes

The Italian market regulator first began tackling this issue in October 2009, when it published a position paper regarding transparency in the ownership of cash-settled derivative positions. Its stated objective was to reach out to the market on the issue, and identify the factors required to correctly evaluate the regulatory options. In the document, CONSOB analysed the key aspects of the phenomenon, and underlined how the use of these derivatives had gradually become more common, allowing their owner to hold economic interests in a particular company's shares without any assignment or transfer of a right to buy or sell the underlying security. The absence of any form of settlement by physical delivery meant that Italian law imposed no specific obligation to report the position.

Such instruments, intended as investments or hedging instruments, have structural characteristics that potentially be used to create positions in shares that are not fully transparent (so called hidden ownership), as confirmed by a number of recent developments in the markets. The party that takes the "short" position in the derivative contract (i.e., the party that takes a position that is financially similar to that of a party who undertakes to deliver the underlying securities at a specific date) tends to hedge the risk it has assumed by purchasing the underlying shares in the market – which means that the parties may in fact agree to physical delivery of the securities when the contract matures. It is similarly possible that the short position holder has no economic interest in voting the shares (so called empty voting), and thus that the holder of the hidden position is able to influence the way in which the short position holder votes.

The absence of transparency for cash-settled derivatives transactions may thus turn out to be critical, to the extent it could potentially alter the system of corporate governance that traditionally assumes a proportional relationship between economic interests and votes. This could compromise market efficiency: if there is a lack of transparency as to a company's owners, the market is missing out on significant information such as the nature of a shareholder, its intentions, and its time horizons. This in turn complicates the market's pricing of the company's value.

Key Issues

New obligation to report "overall long positions" which include cash-settled derivatives

Four new thresholds for notifying overall long positions

Minimum threshold for physically-settled potential shareholdings raised to 5 per cent

Obligation to report physically-settled potential sales abolished

New ad hoc regime for exemptions

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The position paper did not set out any specific regulatory proposal, CONSOB having decided to keep an open mind so that it could analyse the underlying basis for any expansion in the reporting duties connected with cash-settled derivatives.

By the following month, November 2009, Europe had already begun to stir. The European Securities Markets Expert Group, a committee that provides legal and economic advice to the Commission on the application of European Directives related to financial instruments, published its advice, entitled *Views on the issue of transparency of holdings of cash-settled derivatives*. It suggested:

- introducing reporting of derivative positions, which would be declared separately from actual shareholdings (effectively introducing, at least for derivative positions, consistent regulatory treatment across the European Union);
- requiring reporting of both long and short positions, without netting out one against the other; and
- reporting obligations arising only where significant percentages were exceeded (5 or 10 per cent).

This first initiative was followed in January 2010 by a consultation paper which set out the proposal from the Committee of European Securities Regulators (now the European Securities and Markets Authority), for an expansion of the reporting obligations for significant shareholdings under the Transparency Directive, 2004/109/EC, to cover cash-settled derivatives. The European Commission made its own consideration of the main issues arising out of the application of the Transparency Directive and of the areas where there was room for improvement, and finally in May 2010 began a public consultation process on the changes that might be introduced (such as expanded reporting for the holders of voting rights, including derivative instruments settled in cash). The Commission has yet to release proposals for such changes to the Transparency Directive.

CONSOB's new consultation document

Pending greater clarity on the legislative treatment at a European level, in May 2011 CONSOB published a further consultation document, which – in addition to proposing a menu of applicable regulatory options – confirmed the need for a specific reporting treatment for cash-settled equity derivatives (deeming the currently available enforcement measures – such as the notions of interposed persons, and concert parties – insufficient to achieve effective supervision).

In the meantime, between the publication of the original position paper and the new consultation document, CONSOB introduced changes to the rules governing share tender offers (see Client Briefing, Corporate M&A, April 2011 *Consob approves the new takeover bid regulations*), acting under Legislative Decree 58/1998 (the "**Consolidated Finance Act**"), doing so in implementation of the Takeover Directive, 2004/25/EC. As part of that, CONSOB had introduced changes under powers delegated to it by article 105(3-bis) of the Consolidated Finance Act permitting CONSOB to issue regulations governing "the circumstances and manner in which holdings of derivative instruments are included in the calculation of a shareholding". Under the revised rules, the calculation to determine whether an obligation to launch a mandatory tender offer exists now includes all derivative instruments– including those held indirectly– that allocate a so- called "long position" on the underlying share. Such a position is defined as a financial position whereby the contracting party has an economic interest positively correlated to the performance of the underlying shares.

CONSOB's new regulatory regime

Reporting obligations

At the end of the consultation process, CONSOB published a new version of the Regulation on Issuers with a revised treatment of transparency in shareholdings (articles 116-*terdecies et seq.* of the Regulations). Specifically, no changes were made to the reporting obligations for those shareholdings defined in the Regulations as "actual", while the treatment of potential shareholdings was amended as follows:

1. three new definitions were added in connection with the new regime for disclosing cash-settled derivatives:
 - "other long positions": the shares that constitute the underlying for derivative instruments listed in article 1(3) of the Consolidated Finance Act, and any other financial instrument or contract, other than those relevant for the calculation of potential shareholdings, capable of leading to an economic interest that is positively correlated to the performance of the underlying, including also the position of counterparty to the holder of a short position; this definition includes both cash-settled derivative position and physically-settled positions that do not fall within the definition of potential holdings because they do not grant an unconditional right to purchase, meaning the discretion to acquire the underlying shares (among these, for example, the physically-settled sale of a put option).
 - "short position": a financial position in which the contracting party has an economic interest that is negatively correlated to the performance of the underlying; and

- "overall long position": an aggregate position held in shares, potential shareholdings and other long positions;
2. in addition to the "stand-alone" reporting of the actual and potential physically-settled holdings, a new, obligation is added, requiring the reporting of the overall long position (which takes into account, inter alia, the position on cash-settled derivatives) if it exceeds the thresholds of 10, 20, 30 or 50 per cent, and at any time the overall long position falls below any of these thresholds;
 3. to limit the number of reports due as a mere result of activities involving cash-settled instruments performed by those who hold actual and potential physically-settled positions and hover near the thresholds applicable to the overall long position, the new regulations provide that the calculation of the overall long position take into account holdings of cash-settled derivatives only if these exceed the minimum threshold of 2%;
 4. to prevent duplicate obligations, a provision was included to state that the reporting obligation of the overall long position will be deemed complied with if a person exceeds or goes below the threshold as a result of "movements" of actual and/or potential holdings already reported pursuant to the applicable provisions of the Regulation on Issuers;
 5. holders of an actual shareholding, and holders a potential shareholding for purchase on physical settlement terms, in each case exceeding 2%, are no longer required to report potential shareholdings for sale on physical settlement terms that exceed a relevant threshold; thus holders of potential shareholding for sale (for example, holders of a put) will have no reporting obligations;
 6. as a result of the above, the definition of "potential shareholding for sale" and the distinction between "potential shareholding for sale" and "potential shareholding for purchase" are removed; therefore, now the reporting obligations correctly are imposed only on "potential shareholdings", which term is defined as "the shares that constitute the underlying of derivative financial instruments listed in 1(3) of the Consolidated Finance Act, as well as any other financial instrument or contract that, by virtue of a legally binding agreement, confer upon the holder an unconditional right, to be exercised exclusively on the holder's initiative, to acquire the underlying shares through physical settlement";
 7. the notification previously required for potential shareholdings of at least 2 per cent is modified and applies only to potential shareholdings of at least 5 per cent;
 8. it is no longer possible to off-set potential shareholdings and the overall long position against short positions having the same underlying.

Accordingly, to identify the best criterion for aggregating the various components of the interest held (actual shareholdings, physically-settled potential shareholdings, and cash-settled potential shareholdings) to calculate the thresholds, and consequently the related reporting obligations, CONSOB has opted to maintain the current reporting system (subject to the amendments described in 5, 6 and 7, above). Moreover, CONSOB has specified another four "aggregated" thresholds at 10, 20, 30 and 50 per cent, for the calculation of which the cash-settled long positions.

This approach should allow greater transparency as to cash-settled derivatives, to the extent they are used to acquire material economic interests (including where the acquisition is not accompanied by a holding, or an acquisition, of an actual stake); or used, marginally or otherwise (as long as in excess of the 2% threshold), by persons who already hold significant positions. In most cases, investors pursuing merely speculative objectives should remain outside the scope of the new reporting obligations.

The calculation criteria

In response to the views expressed by market participants, CONSOB decided to use the concept of notional amount - that is to say the number of shares constituting the contract's theoretical underlying - to calculate potential shareholdings under cash-settled derivatives. If the number of underlying shares is variable, the reference number will be the maximum number of shares provided for in the financial instrument.

CONSOB has deemed that notional amount would be preferable to a delta adjustment, which is based upon the number of underlying shares actually purchased or sold for the purpose of re-hedging (and which is thus the potential shareholding that the derivative contract would actually allow to be transferred), as this would vary depending upon the trading performance of the stock underlying the derivative instrument.

The exemptions

New exemptions from the obligation to report the overall long positions have been specifically created, and are as follows:

a) other long positions held for the purpose of hedging a client's position by an authorised entity (*soggetto abilitato*), EU investment firm allowed to operate in Italy or another entity authorised by the supervisory authority of a non-EU state with which Consob has a cooperation agreement; so as to allow intermediaries to set off cash-settled long positions held as hedges for identical but opposite client positions;

b) other long positions purchased or sold by a market maker acting in such capacity, even if off the regulated markets and multilateral trading systems, on condition that:

1) such market maker falls within those listed under a); does not interfere in the management of the listed issuer and does not exercise any influence over said issuer for the purposes of acquiring such positions or maintaining the share price; is able to identify the long positions held for the purposes of market making in a manner that may be monitored by Consob, or by holding them in a separate account; and

2) the overall long position does not exceed the 30% threshold; this provision is justified to achieve harmonisation with the legislation governing tender offers, which requires that a tender offer be launched when the overall long position exceeds the 30% threshold in absence of the exemption for market makers;

c) financial instruments connected to financial indices or other fungible financial instruments, assuming certain conditions are met to prevent their use as a potentially elusive measure of the transparency obligations, and especially the condition that the issuer's shares included in the index or underlying the financial instruments included in the index:

1) not represent more than 1% of the overall issued shares; and

2) the shares' weight within the index does not exceed 20% of the overall value of the securities included in the same index.

The transition period

A transition regime has been created to clarify the regime applicable to positions already held on the date when Resolution 17919 becomes effective, whereby any holder – on that date – of a significant overall long position is required to comply with the reporting obligations set out in Resolution 17919 within five trading days.

Resolution 17919 also includes an amended Form 120A, along with the related instructions, which will need to be used starting from 1 December 2011.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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