The Case for Mandatory Ownership Disclosure

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ABSTRACT

The use of equity derivatives to conceal economic ownership of shares ("hidden ownership") is increasingly drawing attention from the financial community, as is the exercise of voting power without corresponding economic interest ("empty voting"). Market participants and commentators have called for expansion of ownership disclosure rules, and policymakers on both sides of the Atlantic are now contemplating how to respond. Yet, in order to design appropriate responses it is key to understand why we have ownership disclosure rules in the first place. This understanding currently appears to be lacking, which may explain why we observe divergent approaches between countries. The case for mandatory ownership disclosure has also received remarkably little attention in the literature, which has focused almost exclusively on mandatory issuer disclosure. Perhaps this is because most people assume that ownership disclosure is a good thing. But why is such information important, and to whom? This paper aims to answer these fundamental questions, using the European disclosure regime as an example. First, the paper identifies two main objectives of ownership disclosure: improving market efficiency and corporate governance. Next, the paper explores the various mechanisms through which ownership disclosure performs these tasks. This sets the stage for an analysis of hidden ownership and empty voting that demonstrates why these phenomena are so problematic.

Keywords: ownership disclosure, market efficiency, corporate governance, monitoring, hidden ownership, empty voting

JEL Classifications: G10, G30, G34, G38, K20, K22

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INTRODUCTION

A "huge question for regulators and arguably an embarrassment for all European capital markets" is how one analyst responded to the news that carmaker Porsche used equity derivatives to silently build up a large stake in Volkswagen in the fall of 2008.[1] The use of equity derivatives to conceal economic ownership of shares ("hidden ownership") is a phenomenon that is increasingly drawing attention from the financial community, as is the exercise of voting power without corresponding economic interest ("empty voting").[2] Market participants and commentators have called for expansion of ownership disclosure rules, and policymakers on both sides of the Atlantic are now contemplating how to respond.

Yet, in order to design appropriate responses it is key for policymakers to understand why we have ownership disclosure rules in the first place. This understanding currently appears to be lacking, which may explain why we observe divergent approaches between countries.[3] The case for mandatory ownership disclosure has also received remarkably little attention in the academic literature, which has focused almost exclusively on mandatory *issuer* disclosure.[4] Perhaps this is because most people assume that ownership disclosure is a good thing.[5] But why such information important, and to whom?

This paper aims to answer these fundamental questions, using the European ownership disclosure regime as an example. A focus on the European regime is useful

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[1] Richard Milne, *Hedge Funds Hit As Porsche Moves On VW*, FINANCIAL TIMES, Oct. 27, 2008. For a discussion of this case, *see infra* note 192 and accompanying text.

[2] The terminology has been introduced by Henry T. Hu & Bernard S. Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811, 815, 816 (2006).

[3] *See* EUROPEAN SECURITIES MARKETS EXPERT GROUP (ESME), FIRST REPORT OF ESME ON THE TRANSPARENCY DIRECTIVE 2 (2007) (suggesting that one of the reasons for the divergent approaches in different European countries appears to be the lack of a clear recognized reason for the imposition of the European disclosure regime). *See also* NIAMH MOLONEY, EC SECURITIES REGULATION 195 (Oxford University Press 2008) (noting that the European disclosure regime suffers from a lack of clarity as to its core objectives).

[4] For a comprehensive overview of this debate, *see* Merritt B. Fox, Artyom Durnev, Randall Morck & Bernard Y. Yeung, *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 Mich. L. Rev. 331, 335-344 (2003).

[5] *Cf.* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) PRINCIPLES OF CORPORATE GOVERNANCE 51 (2004) (referring to ownership disclosure as "one of the basic rights" of investors).

because this regime has been developed fairly recently and a number of justifications have been offered for it. It is also appropriate in light of the fact that the British Financial Services Authority (FSA), which operates within the European framework, has taken the international lead when it comes to adjusting ownership disclosure rules to changed market circumstances. However, the basic insights yielded by the paper can be applied universally and should be of interest to scholars and policymakers around the globe, including the US Securities and Exchange Commission (SEC).

First, the paper identifies two main objectives of ownership disclosure rules: improving market efficiency and corporate governance (Part I). The paper then explores the different mechanisms through which ownership disclosure performs these tasks. This sets the stage for an analysis of hidden ownership and empty voting (Parts 2 and 3, respectively). First, the paper briefly describes some recent high-profile cases that have occurred in Europe and in the US and that illustrate the dramatic effects of hidden ownership and empty voting. Next, the paper analyzes the extent to which these phenomena are captured by existing rules under the disclosure regime. The analysis suggests they are not, at least not effectively. Finally, the paper shows how these phenomena undermine the mechanisms through which ownership disclosure improves market efficiency and corporate governance. Thus, the paper enables a better understanding of why hidden ownership and empty voting are so problematic.

The paper has several important policy implications (Part 4). In general, policymakers contemplating how to respond to hidden ownership and empty voting should not focus only on the most obvious problems caused by these phenomena, such as malfunctioning of the market for corporate control. Instead, they should take into account the whole range of adverse effects described in this paper. Specifically, the European Commission, which is currently evaluating the European ownership disclosure regime, should consider expanding the scope of the disclosure rules. In each case, policymakers should duly take into account the potential costs of increased disclosure, which are highlighted in this paper. The paper concludes by pointing at certain related issues that merit careful consideration, such as the issue of regulatory competition.

I. THE OBJECTIVES OF MANDATORY OWNERSHIP DISCLOSURE

An obligation to disclose major shareholdings was introduced at European level in 1988 with the "Large Holdings Directive".[6] This directive significantly improved transparency levels and enabled large-scale studies of control patterns in Europe.[7] However, its limited scope and application led observers to conclude that it was not generating the data it was supposed to.[8] In 1999, the European Commission announced a range of measures to promote integration of European financial markets. One of the aims was to enable issuers to raise capital on competitive terms across Europe.[9] To achieve this, the Commission intended to update existing disclosure obligations. This resulted in the Transparency Directive, which in its first recital states that

> "[t]he disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency."[10]

To this end, according to the Directive, those who hold or have access to voting rights should disclose major holdings in listed companies.[11] This information

[6] Council Directive 88/627/EEC, On the Information to be Published when a Major Holding in a Listed Company is Acquired or Disposed Of, 1988 O.J. (L 348) 62 (previous directives required issuers to disclose information on share ownership, but did not impose such duty directly on shareholders and required less disclosure). The European Commission's rationale for proposing this directive was that investors would be provided with information on persons capable of influencing management; this would enable them to "follow developments in the company's ownership and gain a clearer idea of what is happening internally." This information, the Commission considered, might affect investors' assessment of the securities and play a crucial role in their investment decisions. *Commission Proposal for a Council Directive on the Information to be Published When Major Holdings in the Capital of a Listed Company are Acquired or Disposed Of*, at 2, COM (1985) 791 final, O.J. (C 351) 8.

[7] *See, e.g.,* THE CONTROL OF CORPORATE EUROPE (Fabrizio Barca & Marco Becht eds., Oxford University Press 2001).

[8] STRONG BLOCKHOLDERS, WEAK OWNERS AND THE NEED FOR EUROPEAN MANDATORY DISCLOSURE 28, 32 (European Corporate Governance Network Executive Report prepared by Marco Becht 1997).

[9] *Communication of the Commission: Financial Services: Implementing the Framework for Financial Markets: Action Plan*, at 22, COM (1999) 232 (Nov. 11, 1995).

[10] Directive 2004/109/EC, On the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market, 2004 O.J. (L 390) 38 [hereinafter Transparency Directive].

[11] *Id.* ¶ 2.

> "should enable investors to acquire or dispose of shares in full knowledge of changes in the voting structure; it should also enhance effective control of share issuers and overall market transparency of important capital movements."[12]

From the recitals and the legislative history of the Directive discussed in further detail below, it can be inferred that the main objectives of the European ownership disclosure regime are (i) improving market efficiency and (ii) improving corporate governance.[13] The following section explores the different mechanisms through which ownership disclosure can perform these tasks.

A. The First Objective: Improving Market Efficiency

One definition of an efficient market is a market in which prices always fully reflect available information.[14] The traditional argument in support of mandatory *issuer* disclosure is that

> "in the absence of regulation, the existence of externalities will result in market failure whereby too little information will be incorporated into share prices. Implicit in this position is the belief that mandatory disclosure rules results in meaningful issuer disclosures that would otherwise not be

[12] *Id*. ¶ 18.

[13] *Cf.* EILÌS FERRAN, BUILDING AN EU SECURITIES MARKET 127, 130 (Cambridge University Press 2004) 130 (identifying improving share price accuracy and addressing corporate governance agency problems as the two key functions of *issuer* disclosure requirements, and stating that the EU issuer disclosure regime is largely designed with a view to improving the accuracy of securities prices in the interests of investor protection and market efficiency, but that is has recently started explicitly addressing corporate governance disclosures).

This paper does not separately address the issue of investor protection. For a compelling argument that disclosure is irrelevant to investor protection, *see* Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 Colum. L. Rev. (forthcoming 2009) (manuscript at 17, available at SSRN: http://ssrn.com/abstract=1115361). *See also* Gaëtane Schaeken Willemaers (forthcoming 2009) (manuscript, on file with author) (developing a similar argument in the European context); PAUL DAVIES, THE TAKE-OVER BIDDER AND THE POLICY OF DISCLOSURE, in: EUROPEAN INSIDER DEALING (Klaus Hopt & Eddy Wymeersch eds., Butterworths 1991), at 261 (noting that ownership disclosure may be thought to contribute to investor confidence, but developing this argument by stating that the focus of the (UK) disclosure rules is on informing the market of certain important facts so that other actors can take appropriate decisions, thus promoting efficiency).

For reasons of space, neither does this paper discus how market efficiency and good corporate governance can lower the cost of capital. For a discussion, *see, e.g.*, Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation around the World*, 2 Brook. J. Corp., Fin. & Com. L. 81, 93 (2007) (the title of which has provided loose inspiration for the title of this paper); Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. Fin. 1, 19 (2006).

[14] Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383 (1970).

forthcoming and that these disclosures add to share price accuracy."[15]

An important study has tested this claim empirically by studying the impact of enhanced issuer disclosure requirements.[16] The authors distinguish between the concept of "price accuracy," which refers to the extent to which share prices offer a good prediction of firms' future cash flows, and "share price informedness": the extent to which a share price reflects the available fundamental information.[17] They define "fundamental information" as information that helps in predicting future cash flows more precisely.[18] The results of the study suggest that share prices became more informed as a result of the enhanced disclosure requirements, which is interpreted as evidence that mandatory issuer disclosure can increase share price accuracy and share price informedness.[19]

To determine whether mandatory ownership disclosure could yield similar benefits, the key questions are (1) whether information on major shareholdings constitutes fundamental information, and (2) whether disclosure of major transactions can be instrumental in conveying other, underlying fundamental information to the market.[20] The remainder of this section shows that both are true.

1. Transparency of the Voting Structure

According to the Transparency Directive, disclosure of major holdings should enable investors "to acquire or dispose of shares in full knowledge of changes in the voting structure."[21] It is useful here to distinguish between the voting structure and

[15] Fox et al., *supra* note 4, at 342.

[16] *Id*.

[17] *Id.* at 345, 350.

[18] *Id.* at 348.

[19] *Id.* at 368.

[20] An important question in the debate on mandatory issuer disclosure is whether it is necessary to mandate issuers to disclose information in order for such information to be impounded in share prices. Some scholars have argued that issuers can be expected to voluntarily disclose their private information as a signal of their products' quality. *See, e.g.,* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation,* 107 Yale L.J. 2359, 2373-80 (1998). Even if this argument holds true for issuers, it is doubtful whether it does so for shareholders, given the difference in incentives between them. For this reason, it is assumed in this paper that a market solution is unlikely to produce a socially desirable level of ownership disclosure.

[21] Transparency Directive, *supra* note 10, ¶ 2.

changes in the voting structure.

a. The Voting Structure

The voting structure determines who controls the company, at least to a large extent.[22] Information on the voting structure constitutes fundamental information, because future cash flows may vary depending on the allocation of control. One way to see how is by looking through the paradigm of agency theory. This shows that different control patterns entail different agency costs, as illustrated by the following classic examples:

In firms with dispersed ownership, no individual shareholder has a strong enough incentive to devote resources to ensure that management acts in the interest of the shareholder.[23] Hence, control is in the hands of management. This implies a risk of managerial slacking, which is a source of agency costs.[24] By contrast, in firms with concentrated ownership the controlling shareholder has a strong incentive to monitor management, as do smaller blockholders.[25] Of course, not all blockholders may find it worthwhile to engage in monitoring.[26] But to the extent they do, they could reduce agency costs.

At the same time, blockholders could be a source of new agency costs, notably by extracting private benefits (e.g., tunneling).[27] There is also a risk of over-monitoring, which may discourage management from showing initiative.[28] In practice, the

[22] *See infra* note 254 and accompanying text.

[23] Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 Bell J. Econ. 42 (1980).

[24] ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 112-116 (New York, Harcourt, Brace & World Inc. 1967); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Finan. Econ. 305 (1976).

[25] *See* Anat R. Admati, Paul Pfleiderer & Josef Zechner, *Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium*, 102 J. Pol. Econ. 1130 (1994).

[26] *See, e.g.,* Marc Goergen, Luc Renneboog & Chendi Zhang, *Do UK Institutional Shareholders Monitor Their Investee Firms?* 8 J. Corp. Law Stud. 39 (2008); Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 Vand. L. Rev. 315 (2008).

[27] *See* HENRY HANSMANN & REINIER KRAAKMAN, AGENCY PROBLEMS AND LEGAL STRATEGIES, in: THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH, REINIER KRAAKMAN ET AL. 22 (Oxford University Press 2004).

[28] Mike Burkart, Denis Gromb & Fausto Panunzi, *Large Shareholders, Monitoring, and the Value*

behavior of blockholders will largely depend on their type (e.g., private investor, institutional investor),[29] on whether there are other blockholders[30] and on the legal environment.[31]

If investors expect the costs resulting from the ownership structure of a particular firm to outweigh the benefits, they may discount the share.[32] Conversely, if they expect the benefits to outweigh the costs, they may be willing to pay more. Because of this trade-off, the impact of the ownership structure is likely to be different for each firm.[33] The function of ownership disclosure is to enable investors to make their own informed assessment as to how the ownership structure of a particular firm may impact the value of the share.[34] This also explains why securities laws typically

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of the Firm, 112 Quart. J. Econ. 693 (1997).

[29] *See, e.g.,* Henrik Cronqvist & Rudiger Fahlenbrach, *Large Shareholders and Corporate Policies*, Rev. Fin. Stud. (forthcoming).

[30] Empirical studies suggest that the presence of multiple blockholders can sort different effects: *see, e.g.,* Luc Laeven & Ross Levine, *Complex Ownership Structures and Corporate Valuations*, 21 Rev. Financ. Stud. 579 (2008) (finding that blockholders fight to form ruling coalitions so that they can extract private benefits); Benjamin Maury & Anete Pajuste, *Multiple Large Shareholders and Firm Value*, 29 J. Banking Finance, 1813 (2005) (finding that firm value increases when voting power is distributed more equally among blockholders).

[31] *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 Harv. L. Rev. 1641, 1652 (2006); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1049 (2007).

[32] *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785 (2003) (discussing the “controlling shareholder tradeoff”).

[33] This may explain why empirical studies into the relationship between types of ownership structure and firm value have produced mixed results; for an overview, *see* Steen Thomsen, Torben Pedersen & Hans Kurt Kvist, *Blockholder Ownership: Effects on Firm Value in Market and Control Based Governance Systems*, 12 J. Corp. Finan. 246, 251 (2006).

Some view the ownership structure of the firm as an endogenous outcome of a maximizing process: Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. Law Econ. 375 (1983); Harold Demsetz & Belen Villalonga, *Ownership Structure and Corporate Performance*, 7 J. Corp. Fin. 209 (2001). However, recent tests seem to confirm the causal direction. *See, e.g.,* Thomsen, Pedersen & Kvist, *supra* note 33; John J. McConnell, Henri Servaes & Karl V. Lins, *Changes in Insider Ownership and Changes in the Market Value of the Firm*, 14 J. Corp. Fin. 92 (2008); Stijn Claessens, Simeon Djankov, Joseph P.H. Fan & Larry H.P Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. Fin. 2741, 2764 (2002). *But see* Rim Zaabar, *Stock Price Response to Mandatory Disclosure of Ownership Changes: Evidence from France* (2008), at 22 (finding no support for a causal interpretation, but offering possible explanations).

[34] *Cf.* Jensen & Meckling, *supra* note 24 at 313 (developing a model showing that when prospective minority shareholders realize that the manager’s interests diverge from theirs, the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager’s interest and theirs); Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: the SEC and the Post-Enron Reform Agenda*, 48 Vill. L. Rev. 1139, 1152 (2003) (noting that the two functions of issuer disclosure, improving market efficiency and addressing agency problems, are inseparable insofar as a valuation decision is impossible without an assessment of the risk that incumbent management will divert to itself the otherwise expected stream of earnings).

require disclosure of the ownership structure in the prospectus and annual accounts.[35]

There is an additional way through which the ownership structure may impact the value of the share. While the key component of share prices is the discounted value of expected future cash flows, they should also consist of a second component: the value of the vote. This value is determined by the likelihood that the vote will be pivotal in a contest for control and the price it will yield in such case.[36] In firms with highly concentrated ownership the likelihood of a control contest will generally be small compared to firms with dispersed ownership. Thus, the ownership structure has an impact on the value of the share via its effects on the probability of a contested acquisition.[37]

b. Changes in the Voting Structure

If information on control is fundamental information, then so must be information on a potential shift in control. Indeed, the rationale of the US disclosure regime is "to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control."[38] This would enable corporations, their shareholders and potential investors to evaluate the possible effects of a change in substantial shareholdings.[39]

A potential shift in control can impact the value of the share in any of the ways described earlier. The appearance of a *potential buyer*, for example a raider or a

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[35] For the EU, *see* Directive 2003/71/EC, On the Prospectus to be Published when Securities are Offered to the Public or Admitted to Trading, Annex I, section VIII, 2003 O.J. (L 345) 64; Commission Regulation 809/2004, As Regards Information Contained in Prospectuses as well as the Format, Incorporation by Reference and Publication of such Prospectuses and Dissemination of Advertisements, Annex I, items 18.1-18.4, 2004 O.J. (L 149) 1; Directive 78/660/EEC (as amended), On the Annual Accounts of Certain Types of Companies, art. 46a (1) (d), 1978 O.J. (L 222) 11; Directive 83/349/EEC (as amended), On Consolidated Accounts, art. 36 (2) (f), 1983 O.J. (L 193) 1.

[36] Luigi Zingales, *What Determines the Value of Corporate Votes?*, 110 Quart. J. Econ. 1048 (1995).

[37] *Id*. at 1048.

[38] *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), cert. denied, 406 US 910 (1972).

[39] It would also enable evaluation of the possible effects of a tender offer. 111 Cong. Rec. 28,259 (1965) (remarks of senator Williams). *But see* Jonathan R. Macey & Jeffrey M. Netter, *Regulation 13D and the Regulatory Process*, 65 Wash. U.L.Q. 131, 144 (1987) (suggesting incumbent management may be the primary beneficiary). *See also infra* note 123 and accompanying text; note 240 and accompanying text.

competitor, could signal an increased probability of a control contest. This should increase the value of the share, a prediction supported by evidence.[40] Alternatively, the appearance of an *activist hedge fund* could signal an increase in monitoring, which explains why empirical studies show abnormal returns around the disclosure of purchases by hedge funds.[41]

Conversely, the exit of an influential shareholder can signal a reduction in monitoring and adversely affect share value. This is illustrated by an empirical study of share price responses in France, which is characterized by family control of listed firms. The study finds negative abnormal returns following sales of substantial stakes and concludes that this is consistent with the view that monitoring by large shareholders increases shareholder value.[42] In sum, the market's response to the shift in control will depend on the past behavior of the exiting shareholder or the expected behavior of the incoming shareholder.

2. Transparency of Capital Movements

Disclosure of major shareholdings, according to the Transparency Directive,

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[40] *See, e.g.,* W.H. Mikkelson & R.S. Ruback, *An Empirical Analysis of the Interfirm Equity Investment Process*, J. Finan. Econ. 14, 523, 534, 535 (1985) (measuring the announcement effects of US 13D filings in the period 1978-80 and documenting that acquisitions by parties who have disclosed that they consider an acquisition of the target result in a statistically significant abnormal return of 7.74% (average two-day initial announcement prediction error).

[41] Alon Brav, Wei Jiang, Randall S. Thomas & Frank Partnoy, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. Fin. 1729, 1755 (2006) (using a sample consisting of 1,059 hedge fund-target pairs for the period 2001-2006, the authors measure effects of Schedule 13D filings and document abnormal return of approx. 2.0% on the filing day and the following day; afterwards, the abnormal returns keep trending up to a total 7.2% in twenty days. The authors conclude that share prices adjust to a level reflecting the expected benefit of intervention, adjusted for the equilibrium probability that the fund continues with its activism and succeeds); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. Fin 187, 208 (2009) (finding statistically significant mean market-adjusted returns of 7.2% over the [–30, +30] window around filing and concluding that the market perceives substantial benefits upon learning that a firm is targeted by a hedge fund activist).

In practice, the line between share price revisions due to the prospect of a takeover and revisions due to the prospect of shareholder activism is somewhat blurry. Brav et al., at 1758, show that acquisitions by hedge funds that can be interpreted as a prelude to a sale of the target company yield the highest returns relative to other types of activism. These findings are consistent with an empirical study by Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, J. Finan. Econ. (forthcoming) (manuscript at 29, available at SSRN: http://ssrn.com/abstract=1003792).

[42] Zaabar, *supra* note 33, at 18 (finding statistically significant abnormal returns of -2.33% during the [-1, +3] window around the disclosure).

should also enhance "overall market transparency of important capital movements."[43] As we will see below, such transparency may improve market efficiency through several mechanisms:

a. Transparency of Economic Interest

The European Commission's initial proposal for the Directive envisaged that disclosure would not only be triggered by exceeding a threshold percentage of voting rights, but also by exceeding a threshold percentage of the *capital*.[44] Moreover, when filing the notification, not only voting rights but also capital interests would have had to be disclosed. These provisions did not make it into the final version of the Directive.[45] Nonetheless, it is instructive to consider the rationale of requiring disclosure of capital interest.

According to the Commission, disclosure of capital interest would have reflected "not only the actual influence an investor on securities markets may take in a publicly traded company, but more generally its major interest in the company performance, business strategy and earnings."[46] The initial proposal also contained a provision stipulating that "[t]he proportion of capital need be notified only to the extent that the [home jurisdiction] allows multiple voting rights to attach to shares and the issuer provides accordingly in its statutes or instruments of incorporation" – i.e., in case of deviations from one share-one vote.[47] Studies have shown that European firms make frequent use of such disproportionate structures, including multiple voting rights shares and non-voting preference shares.[48] Apparently, the

[43] Transparency Directive, *supra* note 10, ¶ 18.

[44] *Proposal for a Directive of the European Parliament and of the Council on the Harmonisation of Transparency Requirements with Regard to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market*, at 43, COM (2003) 138 final (March 26, 2003).

[45] Accordingly, the various references to "capital" were deleted, with the exception of the reference to "transparency of important capital movements" in recital (18) of the Directive. This raises the question of whether this reference might have been unintentionally included. This paper assumes that is not the case.

[46] *Id.* at 18.

[47] *Id.* at 44. Article 4 (1) of Council Directive 88/627/EEC (the Transparency Directive's predecessor), *supra* note 6, contained a similar provision.

[48] *See, e.g.,* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership around the World*, 54 J. Fin. 471, 499 (1999); M. Faccio & L. H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. Finan. Econ. 365, 389 (2002); REPORT ON THE

Commission deemed it desirable that there be transparency of cash flow rights in these firms.

Why do cash flow rights matter? Because they determine the extent to which a controlling shareholder will bear the cost of private benefit extraction and the benefit from increased monitoring. If voting rights exceed cash flow rights, this encourages private benefit extraction because a disproportionate share of the costs thereof will be borne by outside investors. Theoretical models show that disproportionate structures can distort the controlling shareholder's incentives to make efficient decisions with respect to project selection, firm size and roles of control.[49] Other models show they can distort the market for corporate control.[50]

Conversely, higher cash flow ownership discourages private benefit extraction by making it costlier. It also provides the controlling shareholder with a greater incentive to monitor management and to encourage it to optimize cash flow through dividends. In sum, cash flow rights determine the extent to which the controlling shareholder's interests are aligned with the interests of outside investors. The case for one share-one vote, therefore, turns primarily on its ability to match economic incentives with voting power.[51]

Still, it remains controversial whether mandating one share-one vote would be socially beneficial, as illustrated by the hefty debate that has recently taken place in Europe over this issue.[52] While it may be true that disproportionate voting rights encourage private benefit extraction, they also provide a cheaper way to monitor

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PROPORTIONALITY PRINCIPLE IN THE EUROPEAN UNION, ECGI, ISS EUROPE AND SHEARMAN & STERLING (2007), at 24, 25.

[49] Lucian A. Bebchuk, Reinier H. Kraakman & George G. Triantis, STOCK PYRAMIDS, CROSS-OWNERSHIP, AND DUAL CLASS EQUITY: THE MECHANISMS AND AGENCY COSTS OF SEPARATING CONTROL FROM CASH-FLOW RIGHTS, in: CONCENTRATED CORPORATE OWNERSHIP (R. Morck ed., University of Chicago Press 2000), at 295.

[50] Sanford Grossman & Oliver Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. Finan. Econ. 175 (1988).

[51] Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 Harv. L. Rev. 1911, 1945 (1996).

[52] This debate was ended abruptly late 2007 when Commissioner McCreevy announced he would not further pursue the issue. Speech by Commissioner McCreevy at the European Parliament's Legal Affairs Committee (Oct. 3, 2007). This decision was based in part on two academic studies: Mike C. Burkart & Samuel Lee, *One Share -One Vote: the Theory*, 12 Rev. Finance 1 (2008) and Renee B. Adams & Daniel Ferreira, *One Share, One Vote: The Empirical Evidence* 12 Rev. Finance 51 (2008).

management.[53] As a result, the effects of shifting to one share-one vote are likely to vary per firm. The main objection against mandating one share-one vote, therefore, is that one size does not fit all.

The case for *transparency* of disproportionality, however, is much stronger. Transparency signals that the controlling shareholder's incentives are distorted, and thus enables investors to better anticipate agency costs.[54] Some scholars even argue that as long as companies make adequate disclosure, there is little justification to restrict the ability to deviate from one share-one vote.[55] Empirical studies confirm that outside investors price in the expected costs and benefits of disproportionality. They tend to positively value the incentive effect of cash flow ownership, while negatively valuing the entrenchment effect of disproportionate voting rights.[56] This is consistent with the notion that disproportionality can impact the firm's future cash flows, and that information on disproportionality is therefore fundamental information.

b. Transparency of Trading Interest

Transparency of "important capital movements" may also enable the market to understand the interest in the share. As we will see below, disclosure of major transactions can be instrumental in conveying other, underlying fundamental information to the market, thereby accelerating the process whereby such information is impounded in share prices.

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[53] For a discussion of the costs associated with holding large blocks and with monitoring, *see* Admati, Pfleiderer & Zechner, *supra* note 25.

[54] *See* HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, REPORT ON ISSUES RELATED TO TAKEOVER BIDS IN THE EUROPEAN UNION (2002), at 25.

[55] Arman Khachaturyan, *Trapped in Delusions: Democracy, Fairness and the One-Share-One-Vote Rule in the European Union*, 8 EBOR 335, 357 (2007).

[56] *See* Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Valuation*, 57 J. Fin. 1147 (2002) (finding higher valuation (measured by Tobin's Q) of firms with higher cash flow ownership by the controlling shareholder); Claessens et al., *supra* note 33, at 2755 (using a sample of East Asian firms and finding that for the largest shareholders, the difference between control rights and cash flow rights is associated with a value discount, and the discount generally increases with the size of the wedge and that firm value decreases when the control rights of the largest shareholder exceed its cash flow ownership); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. Finan. Econ. 325, 327 (2003) (showing that where private benefit extraction is expected to be high, non-voting shares trade at a deep discount over voting shares).

The starting point of this line of reasoning is that investors may possess fundamental information that is not yet impounded in share prices. Of course, in a perfectly efficient market this would not be possible. But the evidence suggests that equity markets are merely semi-strong form efficient with respect to easily obtained and easily interpreted information.[57] This means there is still money to be made by trading on information that, although public, is hard to obtain or interpret. Traders with the resources to gather and analyze such information might conclude that the share is overvalued or undervalued and capitalize on this insight by selling or buying shares, respectively.[58]

Once the investor starts trading, the fundamental information is impounded in the share price through several mechanisms. First, even in liquid markets major shifts in supply and demand can impact the share price directly, pushing the share price towards a new equilibrium.[59] Second, the resulting movement in share price may enable *price decoding* by other traders who suspect the trading against the market signals the presence of fundamental information and start trading in the same direction.[60] Third, the trading may enable *trade decoding*.[61]

Trade decoding occurs when the attention of other traders is captured by unusual trades. Whether such trades signal the presence of fundamental information will depend on factors such as the volume of the trades, the sequence of trades, the purpose of the trades, the resulting ownership level and last but not least, the identity of the trader – Warren Buffet is but one example of an investor perceived to be well informed.[62] If other traders become convinced the trades are driven by fundamental information, they will start mimicking the informed trader. As a result, the process

[57] LARRY HARRIS, TRADING & EXCHANGES 240 (Oxford University Press 2003).

[58] *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711, 723 (2006) (referring to this type of traders as "information traders," comprising sophisticated professional investors and analysts).

[59] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 570 (1984).

[60] *Id.* at 575.

[61] *Id*.

[62] *See* Aslihan Bozcuk & M. Ameziane Lasfer, *The Information Content of Institutional Trades on the London Stock Exchange*, 40 J. Finan. Quant. Anal. 621, 638 (2005); David Easley & Maureen O'Hara, *Price, Trade Size, and Information in Securities Markets*, 19 J. Finan. Econ. 69 (1987); David Hirshleifer & Siew Hong Teoh, *Herd Behaviour and Cascading in Capital Markets: a Review and Synthesis*, 9 Europ. Finan. Manage. 25, 48 (2003).

whereby the fundamental information is impounded in the share price is accelerated.

How do uninformed traders become aware of unusual trades? Potential sources are the trading book and the stock exchange's transaction reporting system, but these offer limited insight. Traders are able to conceal the volume of their transaction by conducting a series of smaller transactions over time or placing iceberg orders.[63] They are also able to remain anonymous, through the use of intermediaries or by trading in so-called dark pools, trading venues that do not publicly display bid and offer quotes.[64] Finally, they are not required to disclose their intentions or their resulting ownership level.

This brings us to an alternative means through which uninformed traders are alerted: public disclosure of major transactions. Consider the disclosure by a passive mutual fund manager that it has sold its substantial stake in a portfolio company. The sale might be driven by a need for liquidity or a desire to rebalance the portfolio. But it might also be driven by the possession of fundamental information. Thus, the market might interpret the sale as a signal that the share is overvalued.

Whether there is marginal value in mandating disclosure of major transactions depends on how rapidly the fundamental information driving the transactions is impounded in the share price. If the fundamental information becomes fully reflected in the share price before the disclosure is made, there is little point in mandating disclosure. On the basis of a survey of the finance literature, the FSA recently concluded there can be benefits from disclosure in relation to market efficiency.[65] But perhaps the most persuasive argument that disclosure has marginal value is that the market seems to think so. Empirical studies of announcement effects show abnormal returns on both transaction dates and announcement dates, even if there is no overlap between the two.[66]

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[63] Albert S. Kyle, *Continuous Auction and Insider Trading*, 53 Econometrica 1315 (1985); Sugato Chakravarty, *Stealth-trading: Which Traders' Trades Move Stock Prices?* 61 J. Fin. Econ. 289 (2001).

[64] *See* Hans A. Degryse, Mark Van Achter & Gunther Wuyts, *Shedding Light on Dark Liquidity Pools* (manuscript at 3, 6, 13, available at SSRN: http://ssrn.com/abstract=1303482).

[65] FSA, DISCLOSURE OF CONTRACTS FOR DIFFERENCES, CONSULTATION AND DRAFT HANDBOOK TEXT (CP 07/20) (2007), annex 2.

[66] *Id.* annex 3, at 14 (examining the impact on share prices of announcements in the UK in the period January 2006-August 2006 for a subsample of events non-overlapping with disclosure and

Of course, the abnormal returns could be the consequence of the control implications of major transactions, discussed earlier. In such cases, the transaction does not really convey underlying fundamental information; rather, the transaction itself constitutes fundamental information. So we need to take a closer look at the evidence and filter out transactions with control implications. This is difficult because it is not always clear upon disclosure what the control implications are. Two variables are particularly relevant here: the identity of the trader and the purpose of the transaction.

US disclosure rules provide some insight into the purpose of a transaction, at least at the time of the transaction. Qualified parties who purchase shares without the purpose or effect of changing or influencing the control of the issuer file a statement on Schedule 13G, otherwise on Schedule 13D.[67] This has enabled an empirical study that examines the differences between the same blockholder's passive (13G) and active (13D) holdings. The study finds that not only filings of active holdings produce abnormal returns, but also filings of passive holdings, even though the returns are smaller.[68]

By contrast, to draw conclusions from empirical studies with respect to firms listed in Europe, one will often need to rely on the identity of the trader as a proxy for control implications. For example, mutual fund managers may be less likely to monitor than family investors and more likely to gather and analyze complex information on the fundamental value of the share. But mutual fund managers too may act as monitors, and it therefore remains challenging to determine to what extent announcement effects are driven by control implications or by value implications. Empirical studies measuring the announcement effects of transactions by investors who are relatively likely to be perceived as informed traders document

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documenting statistically significant abnormal returns of 0.36% over the [-1, +1] window around the disclosure date).

[67] Exchange Act Rule 13d-1(a), 17 C.F.R. § 240.13d-1. If the investor changes his intention after filing a Schedule 13G, he will need to file a Schedule 13D. For a description of the rule, *see infra* note 157.

[68] Christopher Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists* 14 J. Corp. Finan. 323, 329 (2008) (using a sample of activism campaigns in the US by hedge funds from 1998-2005 and documenting statistically significant market-adjusted returns of 1.64% (passive) and 3.39% (active) over a [-2, +2] window around the disclosure date).

abnormal returns, though again, they are modest.[69]

What matters for present purposes, however, is not the magnitude of the abnormal returns. It is the mere fact that the market responds, at least on average, to the disclosure of transactions that are relatively likely to be driven by fundamental information. This is consistent with the notion that such disclosure can convey underlying fundamental information to the market and thereby accelerate the process whereby such information is impounded in share prices.

One implication is that disclosure of short positions could also contribute to market efficiency. After all, short sales are particularly likely to be driven by fundamental information.[70] There is evidence that disclosure of short sales triggers a significant market response.[71] This suggests that disclosure accelerates the rate at which fundamental information is impounded in share prices.[72] Interestingly, regulators across the globe have responded to the current financial crisis by requiring reporting of short sales to the regulator. Some have gone so far as to require public disclosure.[73] Yet these measures appear to be primarily driven by concerns about market abuse.[74]

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[69] Bozcuk & Lasfer, *supra* note 62, at 631 (measuring announcements effects of institutional block trading activity on the London Stock Exchange from 1993 to 1999 and finding that buys by fund managers result in statistically significant abnormal returns both on the announcement date (CAR [-1, +1] = +1.17%) and in the post-event period (CAR [+2, +40] = 2.33%), and that large sales result in negative abnormal returns on the announcement date (CAR [-1, +1] = - 0.83%) and in the post-event period (CAR [+2, +40] = -2.39%)); FSA, *supra* note 65, annex 3 at 13 (measuring the announcement effects of sales by asset managers and documenting statistically significant abnormal returns (CAR [-2, +2] = - 0.39%). *See also* Steven R. Bishop, *Pre-Bid Acquisitions and Substantial Shareholder Notices*, 16 Australian J. Manage 1, 19 (1991) (measuring the announcement effects of acquisitions by financial institutions in Australia and documenting statistically significant abnormal returns (CAR's of –2.0% in the month prior to disclosure and 0.27% in the month after disclosure).

[70] *See* Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, *Which Shorts are Informed?*, 63 J. Fin. 491 (2008).

[71] Michael J. Aitken, Alex Frino, Michael S. McCorry & Peter L. Swan, *Short Sales Are Almost Instantaneously Bad News: Evidence from the Australian Stock Exchange*, 53 J. Fin. 2205 (1998) (studying a market setting in which information on short trades is transparent just after execution and finding that disclosure of such trades causes prices to decline immediately).

[72] *Id.* at 2222.

[73] FSA, Short Selling (No 4) Instrument 2008/60 (2008); Resolution by the Hellenic Capital Market Commission of Sept. 23, 2008, available at http://www.hcmc.gr/photos/kefalaiagora/files/DS_230908.pdf.

[74] *See infra* note 196 and accompanying text. *But see* FSA, SHORT SELLING, DP09/1 24, 29 (2009) (noting that transparency of short selling can improve pricing efficiency by conveying a signal to the market that a firm is overvalued, and proposing disclosure of short positions by individual investors to the market).

Even if disclosure can accelerate the process whereby fundamental information is impounded in share prices, one should be cautious in concluding that mandating disclosure for this reason would necessarily result in markets becoming more efficient. One reason for caution is that, as the behavioral finance literature teaches us, investors may not necessarily respond rationally. The recent financial crisis has given skeptics further reason to doubt the market's ability to correctly estimate fundamental values. Thus, the FSA recently warned that disclosure of short sales may cause herd behavior, triggering excessive sales and price declines.[75]

Another reason for caution is that by reducing the rewards of trading on fundamental information, disclosure reduces the incentives to search for such information. As Grossman and Stiglitz observed nearly thirty years ago, "[t]here is a fundamental conflict between the efficiency with which markets spread information and the incentives to acquire information."[76] Moreover, investors who are reluctant to reveal their trading strategies may limit their trading activity to avoid triggering disclosure, which could adversely affect liquidity.[77] Mandating disclosure also entails other costs, as we will see below.

c. Transparency of Free Float

Finally, transparency of "important capital movements" enables the market to estimate the size of the free float. In at least one European country this is an explicit objective of the ownership disclosure regime, and perhaps for a good reason: the size of the free float may impact liquidity, which in turn may impact the share price.[78]

First, consider the link between free float and liquidity, that is, the ability to

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[75] *See* FSA, TEMPORARY SHORT SELLING MEASURES, CP09/1, 10, 11 (2009); FSA, *supra* note 74, at 25. *But see* Hirshleifer & Teoh, *supra* note 62, at 26, 52 (noting that practitioners and the media tend to conclude too easily that there is irrational herding).

[76] Sanford Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 Amer. Econ. Rev. 393, 405 (1980).

[77] For instance, hedge fund managers have expressed concern that disclosure of their short sales will encourage mimicking of their trading strategies by other investors: Peter Smith, *Fund Heads Voice Short Selling Fears*, FINANCIAL TIMES, Jan. 7, 2008.

[78] Explanatory Memorandum to Dutch ownership disclosure rules, *Kamerstukken II*, 2002–2003, 28 985, no. 3, at 3.

quickly trade large size at low cost.[79] One can imagine this becomes harder as the number of free-floating shares becomes smaller. There is some research suggesting that a decrease in the free float does indeed adversely affect liquidity, but compelling evidence is scarce.[80] This is different for the link between liquidity and share price. Several studies have tested and confirmed the hypothesis that the more illiquid the stock, the higher the expected return, and thus the lower the share price.[81]

The function of disclosure of major shareholdings, then, would be to enable investors to understand the implications of the size of the free float. Are there one or more large shareholders who are likely to hold on to their shares, for example to exercise control, and how does this affect liquidity? Taking into account expected trading costs, what is a particular share worth paying for? Mandatory ownership disclosure may help answering these questions.

Of course, there are more direct ways of assessing liquidity, notably by looking at trading volume. Ownership disclosure therefore would seem particularly useful to the extent it can help the market interpret *changes* in liquidity. Consider the hypothetical where a reduction in the free-float causes a decline in trading volume and the decline in trading volume causes the bid-ask spread to widen. Market participants could interpret this widening as a signal that someone is trading on private information and may become reluctant to trade. If, however, they are enabled to interpret these developments as the mere result of a reduction in the free float, they may be more likely to continue to trade, thus contributing to liquidity and ultimately market efficiency.

B. The Second Objective: Improving Corporate Governance

The analysis so far suggests that an appropriate degree of transparency of major shareholdings can improve market efficiency, primarily by enabling investors to

[79] Harris, *supra* note 57, at 399.

[80] Kalok Chan, Yue-Cheong Chan & Wai-Ming Fong, *Free Float And Market Liquidity: A Study Of Hong Kong Government Intervention*, 27 J. Finan. Res. 179, 181 (2004).

[81] *See, e.g.*, Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. Finan. Econ. 223 (1986); Claudio Loderer & Lukas Roth, *The Pricing Discount for Limited Liquidity: Evidence from SWX Swiss Exchange and the Nasdaq*, 12 J. Empirical Finance 239, 240 (2005).

anticipate agency costs. This might explain why a recent survey among institutional investors shows that they consider such transparency important for their investment decisions.[82] Yet another explanation is that they consider transparency important because it can play an active role in *reducing* those costs.[83] Indeed, there is a substantial body of literature discussing mandatory disclosure as a means to address agency problems.[84]

Agency problems and the challenge to mitigate their costs form the centerpiece of corporate governance. In Europe, the High Level Group of Company Law Experts has emphasized the potential of disclosure as a mechanism to improve corporate governance.[85] The Commission shares this view, as becomes clear, for example, from the recitals of its Recommendation on executive remuneration:

> "The disclosure of accurate and timely information by the issuers of securities builds sustained investor confidence *and constitutes an important tool for promoting sound corporate governance* throughout the Community. To that end, it is important that listed companies display appropriate transparency in dealings with investors, so as to enable them to express their view [emphasis added]."[86]

In a similar vein, one of the aims of the Transparency Directive is to "enhance effective control of share issuers" by mandating ownership disclosure.[87] As we will see below, there are two mechanisms through which ownership disclosure can improve corporate governance.

1. Ownership Disclosure as an Enforcement Mechanism

In the words of professor Kraakman, disclosure can facilitate enforcement insofar

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[82] Joseph A. McCahery & Zacharias Sautner, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors* (manuscript, at 30, 40, on file with author).

[83] *Id.* at 11.

[84] *See*, *e.g.,* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. Chi. L. Rev. 1047 (1995); Fox, *supra* note 13.

[85] A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, 33, 45, 95 (2002).

[86] Commission Recommendation 2004/913/EC, Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies, ¶ 3, 2004 O.J. (L 385) 55; *see also* ¶ 9.

[87] Transparency Directive, *supra* note 10, ¶ 18.

as it "discourages opportunism in its own right" and "permits other legal controls that deter self-dealing decisions by corporate insiders."[88] To see how ownership disclosure can do this, it is useful to distinguish between firms with dispersed ownership and firms with concentrated ownership, as their need for enforcement is different.

a. Firms with Concentrated Share Ownership

Many European firms have concentrated ownership.[89] In these firms, there is not a problem of "strong managers, weak owners" but rather of "strong blockholders, weak owners."[90] Because of the potential of private benefit extraction by the controlling shareholder and the resulting need for monitoring of such shareholder, disclosure of major holdings is particularly important for these firms.[91] Two examples illustrate this:

First, disclosure may expose the potential for trading on inside information or other forms of market abuse. Large shareholders can be expected to have access to inside information more readily than small shareholders. Under US law, holders of a 10% stake are even deemed to possess insider information and their trading activity is therefore subject to stringent disclosure requirements.[92] The European Commission had the same concern in mind when it proposed the rules on disclosure of major holdings; this would prevent "uncontrollable rumors" and stop "misuse of price-sensitive information."[93]

Today, the prime instrument to prevent this is the European Market Abuse Directive, which contains rules aimed at safeguarding market integrity.[94] The

[88] REINIER KRAAKMAN, DISCLOSURE AND CORPORATE GOVERNANCE: AN OVERVIEW ESSAY, in: REFORMING COMPANY AND TAKEOVER LAW IN EUROPE (Guido Ferrarini et al. eds., 2004), at 96. The following discussion focuses on enforcement by shareholders and enforcement agencies, but in a broader sense transparency can have value to creditors, employees and other stakeholders.

[89] *See* Barca & Becht, *supra* note 7, at 19; La Porta et al., *supra* note 48, at 492; Faccio & Lang, *supra* note 48, at 379.

[90] Becht, *supra* note 8, at 4.

[91] *Id.* at 60. *See also* NIAMH MOLONEY, EC SECURITIES REGULATION 169 (Oxford University Press 2002); DANIEL GROSS & KAREL LANNOO, THE EURO CAPITAL MARKET 127 (Wiley 1999).

[92] Exchange Act Rule 16a-2, 17 C.F.R. § 240.16a-2 (2005).

[93] European Commission, *supra* note 6, at 2.

[94] Directive 2003/6/EC, On Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 096) 16 [hereinafter Market Abuse Directive].

Transparency Directive has a complementary function by identifying shareholders who are not on an insider list but may nonetheless have access to inside information and may be tempted to use it. This facilitates private or public enforcement. Disclosure may also prevent those whose interests are exposed from engaging in abusive practices in the first place, consistent with the notion that sunlight is the best disinfectant.[95]

Second, disclosure of the identity of the person who ultimately controls the firm makes it easier to detect diversion of corporate assets.[96] This is especially true if the counterparty to a related party transaction is also listed, in which case ownership disclosure may reveal that the controlling shareholder holds a stake in both entities and opportunities for tunneling are exposed.

To be sure, in many jurisdictions, issuer disclosure rules already require disclosure of related party transactions. But at least in Europe these only require periodic disclosure.[97] What is needed is some degree of ex ante disclosure.[98] This alerts outsiders to potential conflicts of interest, which may induce them to monitor more intensely. Again, this heightened scrutiny may also discourage the controlling shareholder from engineering related party transactions that are not conducted at arms' length.

A recent study by Djankov et al. offers a cross-country analysis of private enforcement mechanisms that govern related party transactions. One of the findings is that civil law countries tend to have fewer ex ante disclosure requirements than common law countries.[99] The wider conclusions of this study have been nuanced by a study which shows that France, Germany and Italy provide a large array of remedies

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95 LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Frederick A. Stokes Company 1914).

96 Ferrell, *supra* note 13, at 89.

97 Directive 78/660/EEC, *supra* note 35, art. 43 (1) 7(b); Directive 83/349/EEC, *supra* note 35, art. 34 7(b); Transparency Directive, *supra* note 10, art. 5 (4); IAS 24.

98 *Cf.* EUROPEAN CORPORATE GOVERNANCE FORUM, STATEMENT OF THE EUROPEAN CORPORATE GOVERNANCE FORUM ON PROPORTIONALITY, at 2 (2007). Available at http://ec.europa.eu/internal_market/company/docs/ecgforum/statement_proportionality_en.pdf.

99 Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. Finan. Econ. 430, 440 (2008).

against self-dealing.[100] But this study also confirms that disclosure requirements in these countries are not ex ante.[101] As long as this situation persists, disclosure of major holdings may constitute a useful form of ex ante disclosure.

Empirical studies underscore the role of disclosure in mitigating agency costs. One study finds that high disclosure standards are strongly associated with lower levels of private benefits.[102] This finding is consistent with the law and finance literature. In a recent study, La Porta et al. construe a "disclosure index" that includes ownership disclosure as a variable. They find that as disclosure improves, the size of the block premium decreases.[103]

It is true that some claims made by the law and finance literature have been subject to criticism.[104] But even scholars who have gone so far as to construe a new "shareholder protection index" have consistently included ownership disclosure as a variable.[105] This means they too are of the view that ownership disclosure can protect minority shareholders, the principal argument made here and implicitly adopted by the European Commission.[106]

Finally, while the importance of ownership disclosure in this context should not be underestimated, neither should it be overestimated. Shareholders who have amassed such a large stake that they are able to engage in abusive behavior are likely to be known even if they have not publicly disclosed their stake. Moreover, in terms of

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[100] Pierre-Henri Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 ECFLR 491 (2007).

[101] *Id*. at 18.

[102] Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. Fin. 537, 576, 579, 583 (2004).

[103] La Porta et al., *supra* note 13, at 19.

[104] *See, e.g.*, Mathias M. Siems, *What Does Not Work In Comparing Securities Laws: A Critique on La Porta et al.'s Methodology*, 16 Int'l Company and Commercial L. Rev. 300 (2005); CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW & CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD 21 (The University of Chicago Press 2008).

[105] *See, e.g.*, Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach* 7 J. Corp. L. Stud. 17, 49 (2007); Mathias M. Siems, *Shareholder Protection Around the World ('Leximetric II')*, 33 Del. J. Corp. L. 111 (2008); John Armour, Simon F. Deakin, Prabirjit Sarkar, Mathias M. Siems & Ajit Singh, *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis* (May 2008). ECGI - Law Working Paper No. 108/2008. Available at SSRN: http://ssrn.com/abstract=1094355).

[106] *Commission Staff Working Document: Impact Assessment on the Proportionality between Capital and Control in Listed Companies*, at 18, 21, 25, SEC (2007) 1705 (Dec. 12, 2008).

enforcement, ownership disclosure merely represents a first step. The quality of minority shareholder protection will largely depend on minority shareholders' ability to actually hold the controlling shareholder accountable. Still, the fact that mandatory ownership disclosure ensures that investors and regulators are timely informed of potential conflicts of interest, suggests it has marginal value.

b. Firms with Dispersed Share Ownership

While many European firms are characterized by concentrated ownership, there are also numerous firms with dispersed ownership, particularly in the UK.[107] How does ownership disclosure reduce agency costs in these firms?

Before answering this question, it is important to nuance the distinction between firms with dispersed ownership and firms with concentrated ownership. As pointed out by professors Armour and Gordon, we can distinguish two types of firms with dispersed ownership.[108] One is characterized by retail ownership and predominantly found in the US; the other by institutional ownership and predominantly found in the UK. Multiple blockholders can together increase agency costs much like a single controlling shareholder can, by conspiring to extract private benefits.[109] This risk of "intra-shareholder agency costs' requires the same type of enforcement as in firms with concentrated ownership, discussed earlier. Armour and Gordon suggest that this explains why the UK has stringent ownership disclosure rules compared to the US.[110]

In terms of reducing *managerial* agency costs, however, the function of ownership disclosure applies in roughly the same way to both types of firms with dispersed ownership. This is by facilitating the market for corporate control, the mechanism through which management is disciplined by takeovers and the threat thereof.

To be sure, the tone of the political debate at the level of individual European countries suggests that, to put it mildly, vulnerability to takeovers is not always

[107] *See* references *supra* note 89.

[108] John Armour & Jeffrey N. Gordon, *The Berle-Means Corporation in the 21st Century* (manuscript, at 11, on file with author).

[109] *See* Laeven & Levine, *supra* note 30.

[110] *Id.* at 22, 26.

desired. Inevitably, this has ramifications at European level – the complicated legislative process preceding the Takeover Directive springs to mind.[111] Still, it appears that at least the European Commission believes in the virtues of the market for corporate control. The very reason it proposed the Takeover Directive was to create favorable conditions for the emergence of a European market for corporate control.[112] One such condition is that the initial threshold for ownership disclosure is set at the right level, which can be explained as follows.

On the one hand, ownership disclosure can positively impact the market for corporate control. First, by understanding who is in control and determining the size of the free float, potential bidders can estimate the likelihood that their bid will succeed. The High Level Group correctly observed that the lack of transparency of the ownership structure may result in malfunctioning of the market for corporate control.[113] Hence, the Takeover Directive now requires significant direct and indirect shareholdings to be published in the annual report.[114]

Second, transparency of major holdings enables the potential bidder to identify parties who could be approached for irrevocable undertakings.

Third, disclosure enables *other* potential bidders to mount a competing offer by alerting them that a third party is amassing a stake in the target. Disclosure matters here since the larger the toehold, the smaller the likelihood that a competing offer will succeed. This is because the initial bidder will partially bid for its own shares and is therefore able to pay a higher price on the whole.[115] A toehold can also offer a strategic advantage vis-à-vis competing bidders since the refusal of the initial bidder to tender its shares in a competing bid could hamper competing bidders' ability to squeeze out the minority upon completion of the bid.

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[111] Directive 2004/25/EC, On Takeover Bids, 2004 O.J. (L 142) 12 [hereinafter Takeover Directive].

[112] *Commission Staff Working Document: Report on the Implementation of the Directive on Takeover Bids*, at 3, SEC (2007) 268 (Feb. 21, 2007). *See also* High Level Group, *supra* note 54, at 19.

[113] High Level Group, *supra* note 85, at 98.

[114] Takeover Directive, *supra* note 111, art. 10.

[115] Jeremy Bulow, Ming Huang & Paul Klemperer, *Toeholds and Takeovers*, 107 J. Polit. Economy 427, 428 (1999).

The flipside of the coin is that mandatory disclosure of stakebuilding can discourage the initial bidder from making a bid in the first place, at least when the threshold that triggers disclosure is set too low. This is because such threshold limits the size of the toehold a potential bidder can silently purchase and the gains he can realize as a result thereof.[116]

The bidder's gains from stakebuilding can be considered from different perspectives. From an efficiency perspective, they could be considered as a reward for the effort of searching for potential synergies.[117] They could also be considered as a means to finance the relatively high bid premium that target shareholders will expect due to the free-rider problem associated with takeover bids.[118] This way, the bidder will still be able to retain some of the gains from his monitoring upon acquisition of the firm. Even if a third party ends up realizing the synergy gains, sale of the toehold will ensure that search costs are made up for. From this perspective, by reducing the potential gains from acquiring a toehold, mandating early disclosure reduces the incentives to incur search costs, to the detriment of the market for corporate control.[119]

An alternative perspective is offered by the Takeover Directive, which justifies its mandatory bid rule – i.e., the forced sharing of the control premium with other shareholders – by citing the need for protection of minority shareholders and emphasizing that shareholders should be treated equally.[120] However, as argued by professor Enriques, such rule has dubious effects on minority shareholders' welfare, precisely because of the chilling effect on takeover activity, and no justification in terms of equal treatment.[121] Much of his line of reasoning applies equally to the

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[116] RONALD J. GILSON & BERNARD BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 899 (The Foundation Press 1995).

[117] Daniel Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 1 Tex. L. Rev. 1, 13 (1978); Davies, *supra* note 13, at 262.

[118] Grossman & Hart, *supra* note 23, at 45.

[119] Fischel, *supra* note 117, at 13, 22; Macey & Netter, *supra* note 39, at 144; GUIDO A. FERRARINI, SHARE OWNERSHIP, TAKEOVER LAW AND THE CONTESTABILITY OF CORPORATE CONTROL, in: COMPANY LAW REFORM IN OECD COUNTRIES. A COMPARATIVE OUTLOOK OF CURRENT TRENDS (Conference proceedings, forthcoming) (manuscript at 4, available at SSRN: http://ssrn.com/abstract=265429).

[120] Takeover Directive, *supra* note 111, art. 5 (1) and 3 (1) (a).

[121] Luca Enriques, *The Mandatory Bid Rule in the Takeover Directive: Harmonization Without*

limitation of a bidder's profits from stakebuilding on grounds of fairness and equal treatment.[122]

Adding to the complexity is the fact that disclosure functions as an early warning system to management of the target, enabling it to respond, for example, by mounting defensive measures.[123] Mandatory disclosure thus potentially undermines the market for corporate control.[124] Yet disclosure can also be useful, because control contestability comes not only with benefits but also with costs. These include the costs of inefficient takeovers and of insiders responding to takeover threat by behaving myopically.[125] Thus, some protection from takeovers may promote insiders' incentives to increase firm value. Moreover, temporary defenses could benefit existing shareholders by strengthening the board's bargaining position. Once the playing field is leveled, the board can negotiate a higher offer price in the case of a bid that undervalues the target. In addition, the board can encourage others to launch a superior bid.

Outside the takeover context, early disclosure can make life difficult for activist shareholders, particularly in combination with tight rules on acting in concert.[126] Some commentators suggest Germany's recent decision to lower its initial reporting

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Foundation?, 1 ECFLR 440, 448, 452, 456 (2004).

[122] *See also* Fischel, *supra* note 117, at 22 (dismissing the suggestion that pre-tender offer purchases should be regulated as tender offers to prevent the offeror from getting a free ride at the expense of early purchasers by stating that "[t]here is simply no reason why, in a free market economy, all shareholders must be treated equally in this respect"). The Transparency Directive itself requires issuers to ensure equal treatment of shareholders, but does not impose the same requirement on shareholders (Transparency Directive, *supra* note 10, art. 17 (1)). Moreover, equal treatment is only required with respect to shareholders who are in the same position. It is questionable whether this can be said of shareholders who have incurred search costs to obtain fundamental information and shareholders who have not.

[123] Traditionally, this has been one of the purposes of the UK ownership disclosure rules. PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 485 (Sweet & Maxwell 6th ed. 1997).

[124] *See* Macey & Netter, *supra* note 39, at 144; Hu & Black, *supra* note 2, at 841.

[125] For an overview, *see* Burkart & Lee *supra* note 52, at 26.

[126] *See* Macey & Netter, *supra* note 39, at 151; BERNARD BLACK, NEXT STEPS IN CORPORATE GOVERNANCE REFORM: 13D RULES AND CONTROL PERSON LIABILITY, in: MODERNIZING US SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES 201 (K. Lehn & R. Kamphuis eds., Center for Research on Contracts and the Structure of the Enterprise 1992); Joseph A. McCahery & Erik P. M. Vermeulen, *Private Equity and Hedge Fund Activism: Explaining the Differences in Regulatory Responses*, 9 EBOR 535, 567-575 (2008); *Commission Staff Working Document: Report on More Stringent National Measures Concerning Directive 2004/109/EC*, at 10, SEC (2008) 3033 final (Dec. 10, 2008); HEDGE FUND WORKING GROUP, HEDGE FUND STANDARDS CONSULTATION PAPER - PART 2, at 45 (2007).

threshold to 3% may have been driven by the controversial approach of Deutsche Börse by hedge funds in 2005.[127] In some countries, issuers are provided with additional tools to trace suitors. For example, UK listed companies have a statutory right to demand clarification from any person whom they believe to be interested in the company's shares.[128] One expert group has recommended the European Commission consider adopting such a right at European level.[129] Still, this tool may prove of little help if the target is unaware of the stakebuilding.

For policymakers, the challenge is to weigh these competing interests to achieve a balance that inevitably is "delicate and perhaps even unstable."[130] A study by the FSA concludes that overall, by minimizing toeholds and providing information on impending takeovers, ownership disclosure should improve the contestability on the market for takeovers.[131] To the extent this is true, ownership disclosure could be a valuable mechanism to improve corporate governance.

2. Ownership Disclosure as a Communication Tool

Another mechanism through which ownership disclosure can improve corporate governance is by providing a communication tool. In exploring this mechanism, it is again useful to distinguish between different ownership structures.

a. Firms with Concentrated Share Ownership

One function of mandatory *issuer* disclosure is to enable shareholders to make informed corporate governance decisions, such as choosing directors or authorizing fundamental transactions.[132] In Europe, both the Transparency Directive and the Shareholders' Rights Directive explicitly aim to ensure that shareholders can exercise

[127] Dorothee Fischer-Appelt, *Implementation of the Transparency Directive - Room for Variations across the EEA*, 2 Capital Markets L. J. 133, 148 (2007).

[128] UK Companies Act 2006, art. 793.

[129] ESME, *supra* note 3, at 5.

[130] Davies, *supra* note 13, at 262.

[131] FSA, *supra* note 65, annex 2, at 5.

[132] Kraakman, *supra* note 88, at 96 (referring to this as the "educative function" of disclosure).

their rights in an informed manner.[133] In theory, ownership disclosure could benefit shareholders by providing information on conflicts of interest. For example, it could expose a link between a nominated director and the controlling shareholder, or that the counterparty to a transaction that requires shareholder approval is related to the controlling shareholder. However, in firms with concentrated ownership the controlling shareholder will, as a practical matter, determine the outcome of the vote, unless approval of a majority of the minority is required. This limits the extent to which ownership disclosure can improve the quality of the decision making process in the shareholders' meeting.[134]

b. Firms with Dispersed Share Ownership

By contrast, in firms with dispersed ownership there is a more important role for the shareholders' meeting. In these firms disclosure of conflicts of interest of large shareholders could influence the outcome of the vote. But there is perhaps a more important way through which ownership disclosure can improve the quality of the decision making process: by enabling communication between the company and its shareholders, and among shareholders.

Knowing fellow shareholders enables shareholders to exchange thoughts, to agree among themselves and to effectively assert their rights.[135] The ability for institutional shareholders to communicate prior to shareholder meetings is key if they are to play an important role in the governance of portfolio companies, as envisaged by the European Commission.[136] But it may not always be easy to identify fellow shareholders.[137] In many jurisdictions, shareholders will rely on ownership disclosure

[133] Transparency Directive, *supra* note 10, ¶ 22 & art. 17 (2); Parliament and Council Directive 2007/36, On the Exercise of Certain Rights of Shareholders in Listed Companies, ¶ 6 & art. 5, 2007 O.J. (L 184) 17 [hereinafter Shareholders' Rights Directive].

[134] To be sure, this does not mean voting by minority shareholders serves no purpose at all. For a description of conceivable purposes, *see* Dirk Zetzsche, *Shareholder Passivity, Cross-Border Voting and the Shareholder Rights Directive*, 8 J. Corp. Law Stud. 289, 304, 305 (2008).

[135] MATHIAS SIEMS, CONVERGENCE IN SHAREHOLDER LAW 135 (Cambridge University Press 2008).

[136] *Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, at 13, COM (2003) 284 final (May 21, 2003).

[137] *See* Siems, *supra* note 135, at 135.

for this.

Communication between the company and its shareholders is also vital. In order for companies to effectively manage their investor relations, they need to have insight into their shareholder base.[138] This was one of the reasons for the Commission to extend the scope of the disclosure rules to holders of derivatives granting access to voting rights.[139]

There are, of course, other means through which a company can trace the identity of its investors.[140] For instance, in the case of registered shares or dematerialized bearer shares the company may be able to track its investors down the chain of intermediaries. But in practice this may prove burdensome, in particular in the case of cross-border investments or separation of registered ownership from economic ownership.[141] By contrast, an ad hoc disclosure obligation as imposed by the Transparency Directive puts the burden on the investor and thereby ensures timely disclosure of his holdings. Thus, while ownership disclosure in itself may be insufficient for a company to have a complete picture of its shareholder base, it can provide a meaningful contribution. This is evidenced by a survey among US firms, which shows that 25% of respondents learned of activist investors' ownership though an SEC filing.[142]

C. Extending the Framework to Insider Trading

The previous sections have described the mechanisms through which ownership disclosure by major shareholders may improve market efficiency and corporate

[138] *Id*. at 132-147.

[139] European Commission, *supra* note 44, at 19, 25.

[140] For an overview, *see* Siems, *supra* note 135, at 132 - 144.

[141] *Id.* at 138. For an overview of difficulties arising in the cross-border context, *see* REPORT BY THE EXPERT GROUP ON CROSS-BORDER VOTING IN EUROPE (2002), available at http://www.jura.uni-duesseldorf.de/dozenten/noack/texte/normen/amsterdam/final.pdf and Zetzsche, *supra* note 134, at 331. The European Association for Listed Companies (EALIC) has pressed the European Commission to address this issue among other reasons because "investors and issuing companies need to be able to identify key shareholders"; letter from EALIC dated Jan. 12, 2006, available at http://www.europeanissuers.eu. In the US, listed companies also experience difficulties in mapping their shareholder base; *see* Kate O'Sullivan, *Who Owns Your Stock?*, CFO Magazine, Oct. 2007.

[142] REPORT OF THE CONFERENCE BOARD RESEARCH WORKING GROUP ON HEDGE FUND ACTIVISM 22 (2008). Available at SSRN: http://ssrn.com/abstract=1107027.

governance. This section extends the analytical framework to insider trading. It demonstrates that ownership disclosure by insiders essentially performs the same tasks, through the same mechanisms.

First and foremost, disclosure of insider trading may improve market efficiency. To begin, the mere fact that managers own shares constitutes fundamental information. A survey among institutional investors shows that they consider inside ownership key in making investment decisions.[143] Why? Presumably because the lower the level of insider ownership, the higher the agency costs could be due to misalignment between the incentives of outside investors and management.[144] On the other hand, significant inside ownership causes entrenchment, which could increase agency costs. Again, disclosure, by signaling the potential for increased or reduced agency costs, enables investors to anticipate the effects of inside ownership. There is some empirical research suggesting that firm value does indeed vary according to the level of inside ownership.[145]

Disclosure of *trades* by insiders may also contribute to market efficiency. This idea is reflected in the recitals of the Market Abuse Directive, which contains the European rules on insider trading and states that the publication of trades by insiders can be a "highly valuable source of information to investors."[146] First, disclosure of changes in the level of inside ownership allows investors to re-assess incentive and entrenchment effects. Second, disclosure may convey underlying fundamental information driving the trades. Even though the prohibition on trading on non-public information applies, managers can be expected to possess such information and their trades therefore potentially convey new information on the firm's prospects.[147] This

[143] McCahery & Sautner, *supra* note 82, at 40.

[144] *See* Jensen & Meckling, *supra* note 24, at 313. To be sure, the efficacy of certain forms of equity based compensation currently awarded can be questioned; *see, generally,* LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (Harvard University Press 2004). Moreover, the recent financial crisis has given skeptics reason to believe that equity based compensation may distort incentives rather than align them.

[145] *See* Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. Finan. Econ. 293 (1988) (finding that Tobin's Q first increases, then declines, and finally rises slightly as ownership by the board of directors rises). For a discussion of the issue of endogeneity, *see supra* note 33.

[146] Market Abuse Directive, *supra* note 94, ¶ 22.

[147] Of course, insiders' trades can also be conducted for other reasons, including for diversification

is evidenced by studies showing that insiders tend to purchase stock prior to an abnormal rise in stock prices and sell stock prior to an abnormal decline in stock prices.[148]

It may come as no surprise, then, that markets tend to respond to disclosure of insider trading.[149] Moreover, the evidence suggests that the direction and magnitude of the response depends on the information the transaction likely conveys regarding the firm's prospects as well the expected incentive and entrenchment effects.[150]

There is also a case for transparency of disproportionality between voting rights and cash flow rights. As with large shareholders, the extent to which managers' interests are aligned with the interests of other shareholders is influenced by their financial interest in share price performance. Just as the incentives of large shareholders may be distorted if they have disproportionally little capital at stake, so may the incentives of managers who have hedged their equity interest.[151]

Finally, disclosure of insider trading improves corporate governance, by facilitating enforcement. This mechanism is acknowledged in the recitals of the

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and liquidity reasons.

[148] *See, e.g.,* H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. Finan. Econ. 189 (1986); Josef Lakonishok & Inmoo Lee, *Are Insider Trades Informative?*, 14 Rev. Finan. Stud. 79, 93 (2001).

[149] *See, e.g.,* Jana P. Fidrmuc, Marc Goergen & Luc Renneboog, *Insider Trading, News Releases, and Ownership Concentration*, 61 J. Fin 2931, 2949 (2006) (finding that UK directors' purchases and sales generate statistically significant abnormal returns of 3.12% and -0.37% respectively, measured over the two-day window starting with the announcement day). *But see* Lakonishok & Lee, *supra* note 148, at 82 (do not observe any major stock price changes when studying US stock market response to insider trading). *See also* Jesse M. Fried, *Reducing The Profitability Of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. Cal. L. Rev. 303, 354 (1998) (explaining how investors use information on insider trading to determine whether the company's insiders believe (based on their inside information) that the stock is over- or undervalued).

Notice that the fact that markets tend to respond to insider trading allows insiders to anticipate – and exploit - the market's likely response to their trading. *See* Michael J. Fishman & Kathleen M. Hagerty, *The Mandatory Disclosure of Trades and Market Liquidity*, 8 Rev. Finan. Stud. 637 (1995).

[150] Fidrmuc et al. *supra* note 149, at 2933; McConnell et al., *supra* note 33, at 104.

[151] *See* Michael L. Lemmon & Karl V. Lins, *Ownership Structure, Corporate Governance, and Firm Value: Evidence from the East Asian Financial Crisis*, 4 J. Fin. 1445 (2003) (studying a sample of East Asian firms during the region's recent financial crisis and finding that stock returns of firms in which managers have high levels of control rights, but have separated their control and cash flow ownership, are 10-20 percentage points lower than those of other firms, consistent with the view that ownership structure plays an important role in determining whether insiders expropriate minority shareholders); Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625, 706 (2008).

Market Abuse Directive[152] and the related Commission Directive, which states that the information is not only valuable to market participants, but also constitutes a means for authorities to supervise markets.[153]

II. HIDDEN OWNERSHIP

The over-the-counter equity derivatives market has grown exponentially over the last decade, with an estimated notional amount of $10.2 trillion at the end of June 2008, more than half of which was accounted for by derivatives of European shares.[154] Equity derivatives are regularly used by hedge funds to leverage their exposure.[155] But there have been instances where hedge funds, as well as hostile bidders, have used derivatives to influence corporate control, without fully disclosing their interests.

Although the terms of cash settled derivative contracts such as options and contracts for differences (Cfd) inherently do not stipulate a transfer of the reference shares, such contracts may, as a practical matter, involve actual shares.[156] The reason is that the short party, usually an investment bank, will typically hedge its position by acquiring the reference shares. This raises two potential issues:

A first issue is that the bank may be inclined to exercise the voting rights attached to the reference shares according to the preferences of its counterparty, for example a hedge fund. The bank will generally be indifferent to the voting rights, while the fund has an economic interest in the shares. The bank will thus have a commercial incentive to accommodate the fund's wishes regarding the exercise of the voting rights. Yet under existing rules, the fund may be able to avoid disclosure of its ability

[152] Market Abuse Directive, *supra* note 94, ¶ 26.

[153] Commission Directive 2004/72/EC, As Regards Accepted Market Practices, the Definition of Inside Information in Relation to Derivatives on Commodities, the Drawing Up of Lists of Insiders, the Notification of Managers' Transactions and the Notification of Suspicious Transactions, ¶ 7, 2004 O.J. (L 162) 70.

[154] BANK OF INTERNATIONAL SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE FIRST HALF OF 2008, 3 (2008).

[155] *See* Kahan & Rock, *supra* note 31, at 1062; Brav et al. *supra* note 41, at 1748.

[156] *See* FSA, *supra* note 65, at 11 (referring to a Cfd on a share as a derivative product that gives the holder an economic exposure, which can be long or short, to the change in price of a specific share over the life of the contract, and offering a detailed description of Cfd).

to influence control, resulting in a lack of transparency.

A second issue is that a cash settled derivative contract, despite its terms, may be physically settled. Once the contract has expired, the bank will have to unwind its position by disposing of the reference shares. If it concerns a substantial stake, the bank may not be able to sell the shares in the market without depressing the share price. By instead transferring the shares to the counterparty if so requested, the bank can simultaneously avoid lower proceeds and accommodate its client. Again, under existing rules, the fund may be able to avoid upfront disclosure of its ability to eventually acquire the shares, resulting in a lack of transparency.

These two issues have materialized, for example, in the context of a high profile battle between activist hedge fund TCI and CSX, a major US railroad company. TCI had amassed a significant stake in CSX partly through total return swaps (TRS), the US equivalent of Cfd, which it had not immediately disclosed. CSX felt this had enabled TCI to ambush CSX in the run-up to a proxy contest and sued TCI for violation of US securities laws. The case focused on whether TCI qualified as beneficial owner of the reference shares, in which case it would have been subject to a disclosure obligation.[157] The key question was whether TCI had a "significant ability" to affect how voting power or investment power with respect to the reference shares would be exercised.[158]

As to *investment power*, the court observed that TCI had significantly influenced its counterparties to purchase or sell CSX shares.[159] This conclusion was based on the fact that (i) it was inevitable, due to the "very nature" of the TRS, that TCI's counterparties would hedge the TRS by purchasing CSX shares, (ii) this is what TCI contemplated, and (iii) the counterparties did in fact hedge their positions.[160] This also explains why TCI limited the size of its TRS with individual counterparties: to

[157] Rule 13d-3(a) of the Exchange Act, 17 C.F.R. 240.13d-3(a) (a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (i) voting power which includes the power to vote, or to direct the voting of, such security; and/or, (ii) investment power which includes the power to dispose, or to direct the disposition of, such security).

[158] *CSX Corporation v. The Children's Investment Fund Management (UK) L.L.P. et al.* (1:08-Cv-02764-Lak (Filed Mar. 17, 2008) (S.D.N.Y.), at 51.

[159] *Id.* at 61.

[160] *Id.* at 52, 60.

avoid triggering a disclosure obligation on their part.[161] Moreover, the court observed that the fact that TCI had the ability to agree to unwind the swaps in kind meant that the hedge positions "hang like the sword of Damocles over the neck of CSX."[162]

As to *voting power*, the court found there was reason to believe that TCI was in a position to influence the exercise of voting rights by its counterparties, especially Deutsche Bank.[163] This finding relied primarily on the fact that while TCI had initially entered into TRS with multiple banks, it had subsequently concentrated its TRS in Deutsche. In doing so, TCI was motivated by the belief that it could influence how Deutsche voted its CSX shares.[164] Remarkably, Deutsche next recalled the shares, which it had lent out, in order to be able to vote them at the shareholders meeting where the proxy battle would be decided. Whether it did so pursuant to an explicit or implicit agreement with TCI was, in the court's view, a "close one."[165]

Ultimately, the court did not hold that TCI directly qualified as beneficial owner, but merely that TCI should be *deemed* beneficial owner because it used the swaps to evade the disclosure obligation. Still, the decision went further than the decision by German regulator BaFin in a recent case concerning the takeover of automotive company Continental by Schaeffler. Before Schaeffler announced its unsolicited offer in the summer of 2008, it had built up a stake comprising just below 3% of shares, just below 5% of call options and approximately 28% of cash settled equity swaps.[166] Yet, while it essentially held a 36% stake, the composition of the stake had enabled Schaeffler to refrain from making any prior disclosure. Consequently, both the market and Continental were caught by surprise. Despite public outcry, BaFin concluded there had been no violation since it had been unable to find evidence of

[161] *Id.* at 53.

[162] *Id.*

[163] *Id.* at 61.

[164] *Id.* at 27, 56. A hedge fund within Deutsche Bank, Austin Friars Capital, also had a proprietary position in CSX, and Deutsche Bank was involved with TCI's initial plans for CSX.

[165] *Id.* at 58.

[166] Dirk A. Zetzsche, *Continental AG vs. Schaeffler, Hidden Ownership and European Law - Matter of Law or Enforcement?*, EBOR (forthcoming 2009) (manuscript at 7, 8, available at SSRN: http://ssrn.com/abstract=1170987).

agreements that would have triggered disclosure obligations.[167]

These are not unique cases. Professors Hu and Black, who have coined the term "hidden (morphable) ownership" to describe the combination of undisclosed economic ownership plus probable informal voting power, have identified a number of cases across the globe.[168] These have changed the political economy and spurred lawmakers into action. The UK Takeover Code now requires economic interests to be disclosed during offer periods.[169] The scope of the general UK disclosure regime is about to be expanded along the same lines.[170] Similar regulatory developments have occurred in Switzerland, Australia and Hong Kong.[171] In other jurisdictions, such as France and Canada, regulators are contemplating amending the rules.[172] Courts have also addressed the issue, for example in New Zealand and Italy.[173] Nonetheless, the issue has only marginally received attention at European level thus far.

A. Existing Disclosure Requirements

To ensure disclosure by the beneficial owner, the Transparency Directive extends

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[167] Press Release, BaFin, No Breach of Reporting Requirements Identified in Continental AG Takeover Procedure (Aug. 21, 2008) (on file with author). For a critique, *see* Zetzsche, *supra* note 166, at 34.

[168] Hu & Black, *supra* note 151.

[169] UK Takeover Code, art. 8 (3).

[170] FSA, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: FEEDBACK AND POLICY STATEMENT ON CP07/20, AND FURTHER TECHNICAL CONSULTATION, CP08/17, 3 (October 2008); FSA, DISCLOSURE OF CONTRACTS FOR DIFFERENCE: FEEDBACK ON CP08/17 AND FINAL RULES (March 2009).

[171] Ordinance of the Swiss Federal Banking Commission on Stock Exchanges and Securities Trading, art. 13; AUSTRALIAN TAKEOVERS PANEL, GUIDANCE NOTE 20 EQUITY DERIVATIVES (2008); HONG KONG SECURITIES & FUTURES COMMISSION, OUTLINE OF PART XV OF THE SECURITIES AND FUTURES ORDINANCE (CAP. 571) - PISCLOSURE OF INTERESTS (2003).

[172] RAPPORT SUR LES DÉCLARATIONS DE FRANCHISSEMENT DE SEUIL DE PARTICIPATION ET LES DÉCLARATIONS D'INTENTION GROUPE DE TRAVAIL PRÉSIDÉ PAR BERNARD FIELD, MEMBRE DU COLLÈGE DE L'AMF, 12 (2008); CANADIAN SECURITIES REGULATORS, PROPOSED NATIONAL INSTRUMENT 55-104 INSIDER REPORTING REQUIREMENTS AND EXEMPTIONS, COMPANION POLICY 55-104CP INSIDER REPORTING REQUIREMENTS AND EXEMPTIONS AND RELATED CONSEQUENTIAL AMENDMENTS, 9 (2008).

[173] New Zealand: 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.); Italy: Sentenza Della Corte D'appello Di Torino Sezione Prima Civile 5.12.2007/23.1.2008, available at http://www.consob.it (technically, this case was about wrongful disclosure made by the companies involved when they responded to questions by Consob with respect to their intentions concerning the control of FIAT); *see also* Lisa Curran & Francesca Turito, *Fiat/ Ifil: The Securities Law Implications for Equity Derivatives*, 21 JIBFL 298 (2006); GUIDO FERRARINI, PRESTITO TITOLI E DERIVATI AZIONARI NEL GOVERNO SOCIETARIO', in LA SOCIETÀ PER AZIONI OGGI, COLLANA DELLA RIVISTA DELLE SOCIETÀ 629 (Balzarini, Carcano, Ventoruzzo eds., 2007).

disclosure obligations to parties deemed to have access to voting rights, so that "publicly traded companies are informed not only about security holders, but also about those who may effectively exercise lots of influence."[174] Consequently, disclosure obligations also apply when, for example, voting rights are held by controlled entities.[175] Various criteria are used to try to capture the beneficial owner, such as "power to exercise dominant influence or control," "discretion," "instruction" and "independently."[176] Here, the Directive lets substance prevail over form.

Disclosure obligations are also extended to parties acting in concert or to parties on whose behalf shares are held by a third party.[177] Moreover, they are extended to holders of certain equity derivatives, because the Commission acknowledges that "[i]nfluence may be directly exercised on companies through shares, but also indirectly through financial instruments conferring the *right* to acquire or sell shares [emphasis added]."[178] This suggests a more formal approach.

Indeed, in the case of Cfd that do not grant a right of acquisition of the underlying shares at settlement, there is no obligation to disclose pursuant to article 13 of the Directive.[179] This article stipulates that call options and similar instruments count towards the trigger of a disclosure obligation. But it only covers instruments that grant the holder, on maturity, "either the unconditional right to acquire the underlying shares or the discretion as to his right to acquire such shares or not," which right must derive from an agreement that is binding under applicable law.[180] This

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[174] European Commission, *supra* note 44, at 25. Conversely, exemptions from notification requirements are available to parties who merely qualify as shareholder in name; *see, e.g.*, Transparency Directive, *supra* note 10, art. 9 (4) and 5 (b).

[175] *See* Transparency Directive, *supra* note 10, art. 10 (e). Relatedly, the definition of "shareholder" provided by article 2 (1) (e) of the Directive encompasses persons who hold shares directly or "indirectly."

[176] Transparency Directive, *supra* note 10, art. 10 (e) jo. 2 (1) (f) (iv) and art. 10 (f); art. 12 (4) jo. art. 10 of Commission Directive 2007/14/EC, Laying Down Detailed Rules for the Implementation of Certain Provisions of Directive 2004/109/EC, 2007 O.J. L (69) 27.

[177] Transparency Directive, *supra* note 10, art. 10 (a) and (g).

[178] European Commission, *supra* note 44, at 18.

[179] *See* CESR, CESR'S FINAL TECHNICAL ADVICE ON POSSIBLE IMPLEMENTING MEASURES OF THE TRANSPARENCY DIRECTIVE, CESR /05-407, 63 (2005). *But see* CESR, *supra* note 187, at 2 (announcing that it will address the possibility of application of the notifications regime to derivative products).

[180] Commission Directive 2007/14/EC, *supra* note 176, art 11 (1).

formalistic approach does not take into account that in practice there can be a thin line between formal rights and de facto powers.

Similar difficulties arise when applying the provisions regarding acting in concert to Cfd. paper 10 (a) of the Directive refers to the conclusion of an agreement that obliges the parties to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer. Again, the emphasis is on the existence of an agreement, which renders it unlikely that a disclosure obligation arises if a bank votes while merely taking into account the preferences of its client.[181]

Possibly, voting rights attached to underlying shares held by the short party could, under certain circumstances, be considered to be held "on behalf of" the long party within the meaning of article 10 (g) of the Directive.[182] At least among German and Portuguese lawyers there apparently is consensus that a contractual scheme leads to the short party holding the underlying shares "on behalf of" the long party if the latter (1) bears the economic risk and (2) is capable of influencing how voting rights are exercised.[183] On the basis of this interpretation, professor Zetzsche has developed a compelling argument that equity swaps such as those employed by Schaeffler should trigger a disclosure obligation under this article.[184]

Whether this interpretation prevails across Europe, however, remains to be seen. In providing advice on the implementation of this article, the Committee of European Securities Regulators (CESR) has offered the example of a trust, which suggests a somewhat narrower interpretation.[185] The FSA, in conducting an extensive analysis of Cfd in relation to existing disclosure obligations, did not refer to the article or to its UK law equivalent.[186] Nor does the fact that market participants,

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[181] CESR, *supra* note 179, at 29.

[182] Relatedly, the definition of "shareholder" provided by article 2 (1) (e) (ii) of the Transparency Directive, *supra* note 10, encompasses persons who hold shares in their own name, but "on behalf of" another person.

[183] *See* Zetzsche, *supra* note 166, at 20.

[184] *Id*.

[185] CESR, *supra* note 179, at 33.

[186] FSA, IMPLEMENTATION OF THE TRANSPARENCY DIRECTIVE; INVESTMENT ENTITIES LISTING REVIEW, CP/064, 49 (2006).

commentators and even the European parliament have called upon the European Commission to increase transparency suggest that current rules provide adequate disclosure.[187] The following section explains why this is a concern.

B. Understanding Why Hidden Ownership is Problematic

Part 1 has provided a taxonomy of the mechanisms through which ownership disclosure improves market efficiency and corporate governance. The following section uses this taxonomy a framework for analysis of hidden ownership. The analysis shows that hidden ownership severely undermines these mechanisms. Thus, it becomes clear why hidden ownership is so problematic.

To begin with, hidden ownership distorts the view of the voting structure. This point is eloquently made by the court in *CSX*, which describes how accumulating shares to hedge equity derivatives may alter the "corporate electorate": (1) it may eliminate the shares from the "universe of available votes" because the banks have a policy of not voting hedge shares, (2) it may subject "the voting of the shares to the control or influence of a long party that does not own the shares," or (3) it may result in the shares being voted by an institution "that has no economic interest in the fortunes of the issuer" but "is aware that future swap business from a particular client may depend upon voting in the 'right' way."[188]

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[187] *See, e.g., Synthesis of the Comments on the Third Consultation Document of the Internal Market and Services Directorate-General: "Fostering an Appropriate Regime for Shareholders' Rights"*, at 14 (Sept. 2007) (respondents suggest that the Commission address the issues raised by derivatives); CESR, FEEDBACK STATEMENT, CESR/08-66, 2 (2008) (respondents suggest that CESR consider application of the notification regime to derivatives); *European Parliament: Resolution of 23 September 2008 with Recommendations to the Commission on Transparency of Institutional Investors*, (2007/2239(Ini)), ¶ O & art. 1 (2008) (stating that "some over-the-counter (OTC) products could use more open or visible trading systems in order to (…) to give an indication of potential ownership changes" and calling for more transparency of hedge funds); the preceding report HEDGE FUNDS: TRANSPARENCY AND CONFLICT OF INTEREST, EUROPEAN PARLIAMENT - REPARTMENT FOR ECONOMIC AND SCIENTIFIC POLICY, 28 (2007) (noting that a case can be made for all notifications of large shareholdings under the Transparency Directive to include (a) significant (3% or greater) short positions, and (b) also any derivative positions, whether long or short); letter from the European Association for Listed Companies (EALIC) to Commissioner McCreevy dated Sept. 14, 2007, at 3 (describing lack of transparency caused by derivatives and asking whether CESR would support an extension of the scope of the major holdings disclosure provisions), available at http://www.europeanissuers.eu; Hu & Black, *supra* note 2, at 836; Moloney, *supra* note 3, at 195; Elizabeth Fournier, *Europe Needs Coordinated Cfd Disclosure*, IFLR, Oct. 2008; John C. Coffee, *Regulators Need to Shed Light on Derivatives*, FINANCIAL TIMES, June 29, 2008.

[188] *CSX Corp.*, *supra* note 158, at 11.

Hidden ownership also distorts the view of *changes* in the voting structure. Consider the use of cash settled equity derivatives to facilitate a creeping takeover. Although a change in control is imminent, the stakebuilding is not disclosed and investors are unable to assess the implications for the value of the share.[189]

Moreover, hidden ownership affects transparency of capital movements. First, the long party's interest remains undisclosed. Yet, its economic ownership *exceeds* its formal voting rights, which means there is no increased incentive to extract private benefits. On the contrary, the long party will often have an increased incentive to encourage maximization of cash flow through dividends. To the extent the long party can influence corporate decision-making, it may therefore be risk-averse to a different degree than ordinary shareholders. Admittedly, lack of transparency of this fact appears to be of relatively slighter concern.

Second, the heightened interest in the share remains undisclosed. If the bank acting as counterparty discloses its purchase of reference shares, the market may attach less significance to this than it would if the purchase was made by a hedge fund known for identifying undervalued targets. If the fund enters into derivative contracts with multiple banks and limits the size of individual contracts to avoid disclosure on their part, the market does not even learn of the increased interest in the share at all, other than through a possible shift in supply and demand. As a result, the fundamental information that may drive the fund's transactions is impounded in the share price at a slower rate than if its transactions were fully disclosed.

Indeed, one of the reasons cited by the UK Takeover Panel to expand the scope of its disclosure rules to economic interests was that this would enable shareholders to understand why share prices may be moving in a particular direction.[190] But this argument is not shared by the FSA in the context of the general UK disclosure regime. In response to calls for greater transparency of Cfd irrespective of their control implications, the FSA has stated it does not have compelling evidence of market

[189] The European Commission acknowledges this possibility, noting that in practice, cash settled options may facilitate the localization of blocks of shares at a later point in time, even though a legal entitlement to purchase such shares does not exist; European Commission, *supra* note 126, at 11.

[190] THE PANEL ON TAKEOVERS AND MERGERS, DEALINGS IN DERIVATIVES AND OPTIONS, CONSULTATION PAPER PCP 2005/1, 11 (2005).

failure in respect of inefficient price formation caused by a lack of transparency.[191]

Third, hidden ownership may distort the market's perception of the size of the free float. If equity derivatives are entered into with a number of banks and the volume of each transaction is kept below the initial threshold for disclosure, the free float may be significantly reduced because the hedge shares are effectively taken out of the market. Yet in contrast to the situation where one party amasses a stake and makes appropriate disclosure, the market remains unaware of this.

Consider the case of carmaker Porsche, which late 2008 disclosed that it had increased its economic stake in Volkswagen from 35% to 74.1% through cash settled options.[192] As a result, the free float had effectively been reduced to a mere 5.8%, assuming Porsche's counterparties had hedged their positions by acquiring the underlying shares. Until Porsche made its disclosure, this reduction in free float had remained invisible because Porsche had not been required to disclose its stakebuilding and liquidity was offered by hedge funds who were massively betting on a decline in Volkswagen's share price by borrowing shares and selling them short. As reported by the *Financial Times*, Volkswagen's shares more than doubled after Porsche's disclosure, as hedge funds, "rushing to cover short positions, were forced to buy stock from a shrinking pool of shares in free float."[193] A leading corporate governance expert observed that the incident "should get the politicians and supervisory authorities to think again about allowing this untransparent situation."[194]

Hidden ownership also undermines the mechanisms through which ownership disclosure improves corporate governance. Transparency of economic interests facilitates enforcement of the prohibition of trading on inside information, or, more generally, the prohibition of market abuse. Regulators worldwide have applied this line of reasoning recently when they mandated disclosure of short positions.[195] So has the

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[191] FSA, *supra* note 170, at 9.

[192] Milne, *supra* note 1.

[193] *Id*.

[194] *Id*. To be sure, the risk of a squeeze is inherent to short selling. The size of the free float can merely give the market some indication of potential supply. To give the market an indication of potential demand, it would need information on the aggregate short position in a single stock. *See* FSA, *supra* note 74, annex 3, at 7.

[195] *See, e.g.,* SEC Release No. 34-58785, at 8; FSA, *supra* note 75, at 10; FSA, *supra* note 75, at 10.

European Commission in a recent paper on hedge fund regulation.[196]

The primary concern in the area of enforcement, however, is that the undisclosed use of equity derivatives can affect the market for corporate control, by putting the acquirer at an advantage over other players in the game. As we have seen, if the objective is to facilitate the market for corporate control, setting the trigger for disclosure at the appropriate level is key. On the one hand, a bidder's ability to use equity derivatives to acquire a toehold can facilitate takeover bids.[197] But if the target company's ability to bargain for a higher offer price is limited or if potential interlopers are discouraged from launching a competing offer, overall the market for corporate control may be adversely affected.[198]

The market for corporate control does not operate solely through public offers. Control can also shift through contested director elections, as in *CSX*. A shift in control can even be initiated by a minor shareholder who puts a controversial item on the agenda. This is exemplified by the case of Dutch bank ABN AMRO. Early 2007, TCI (indeed, the same hedge fund as in *CSX*) initiated a shareholder vote on the break-up of the company. The resolution was partially adopted and while it was not legally binding on the board, it would set in motion a string of events eventually leading to the break-up of ABN AMRO as a result of a public offer by a consortium of three European banks.

By using equity derivatives, shareholders who merely hold sufficient shares to put an item on the agenda of the shareholders' meeting may in fact hold a much larger economic interest. They may also hold a *smaller* economic interest, which implies a risk of empty voting, discussed in the following section. In both cases, it is impossible to determine the relevant shareholder's true interest and hence its incentives and potential influence. This raises real concerns for issuers, as evidenced by the fact that by late 2008, no less than 369 US issuers had amended their bylaws to require full disclosure of derivative positions by shareholders submitting a proposal or nominating

[196] *Working Document of the Commission Services (DG Internal Market): Consultation Paper on Hedge Funds*, at 6 (2008).

[197] Hu & Black, *supra* note 2, at 825.

[198] The European Commission acknowledges that mandatory disclosure of equity derivatives can impact the market for corporate control in both positive and negative ways; European Commission, *supra* note 126, at 12.

directors for election at shareholder meetings.[199]

Finally, as far as the educative function of disclosure is concerned, a concern might be that equity derivatives make it more difficult for issuers to know who has a stake in them. Recall that this issue was on the Commission's mind when it extended the scope of the disclosure obligation to derivatives granting the right of access to voting rights. Can the same argument be invoked to mandate disclosure of equity derivatives that may offer *informal* access to voting rights, such as Cfd? Issuers certainly seem to believe so.[200] The FSA has dismissed this concern on the ground that it sees no evidence of a market failure here.[201] But with barriers to cross-border investment fading away and issuers seeing their shareholder base becoming increasingly widespread, the importance of managing investor relations is only growing. Against this background, there may well be reason for concern.

III. Empty Voting

Hu and Black have characterized as "empty voters" persons whose voting rights substantially exceed their net economic ownership.[202] They describe how equity derivatives enable shareholders to hedge their economic interest and even create negative net economic ownership. Providing an example that by now is well known, they describe how a hedge fund, Perry Corp, held a large stake in a pharmaceutical company, King, that became the subject of a takeover bid. The fund stood to profit from a takeover premium, except that it was uncertain whether the deal would gain approval by the shareholders of the bidder, Mylan Labatories. To secure its profits, Perry took matters into its own hands and acquired a substantial stake in Mylan. This would enable it to vote for approval of the deal. Perry, however, hedged its stake in Mylan, leaving it with no economic exposure but full voting rights. Thus, it could be

[199] Alexia Robinson, *Addressing the Issue of Derivative Disclosure in Advance Notice Requirements*, Sharkrepellent.net, Dec. 16, 2008. Available at https://www.sharkrepellent.net/pub/rs_20081216.html.

[200] Letter from EuropeanIssuers to European Commissioner Charlie McCreevy dated Dec. 12, 2008 (calling for increased transparency, because, among other reasons, undisclosed stakebuilding through Cfd "leaves the issuer in the dark as to who owns the company"), available at http://www.europeanissuers.eu.

[201] FSA, *supra* note 170, at 9.

[202] Hu & Black, *supra* note 2, at 825.

expected that in exercising its voting rights, Perry would be guided by its interests in the target rather than its interests as a shareholder in Mylan, potentially to the detriment of other Mylan shareholders.

Hu and Black further describe cases of "record date capture," instances where parties borrow shares prior to the voting record date in order to vote the shares and return them afterwards. More generally, they describe cases, in the US as well as Europe - in which shareholders have been able to exercise voting rights without a corresponding economic interest, apparently manipulating the outcome of votes in order to realize personal gains. Thus, empty voting potentially poses a serious threat to the quality of the decision-making process in shareholders' meetings of listed companies, which explains why the issue has drawn attention from market participants,[203] regulators (including the SEC)[204] and academics.[205] In spite of this, the issue has, again, only received marginal attention at European level.[206]

To be sure, just as it can be legitimately questioned whether mandating one share-

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[203] European Commission, *supra* note 187, at 3, 14 (showing that there is general support among respondents for measures enhancing transparency of stock lending and that a majority of respondents believes that the issue needs to be addressed at EU level); CESR, *supra* note 187, at 2 (respondents advocate application of the notifications regime to stock lending and derivatives); European Corporate Governance Forum, *supra* note 98, at 2 (suggesting that shareholders holding in excess of a certain percentage of outstanding share capital of e.g. 1% or 3% should be required to disclose to what extent and by what means they have reduced their economic risk resulting from such shareholding); the responses to both consultations and the letter of Dec. 12, 2008 by EuropeanIssuers (advocating complete transparency of stock lending towards all concerned parties, including the issuer). Available at http://www.europeanissuers.eu.

[204] *See, e.g.*, a speech by SEC staff (John White), *Don't Throw Out Baby With Bathwater*, Keynote address at ABA section of business law fall meeting (Nov. 21, 2008). In Delaware, where many US Fortune 500 companies are incorporated, the Delaware General Corporation Law may soon be amended to partially respond to empty voting. *See* Michael B. Tumas & John F. Grossbauer, *Proposed Amendments to the Delaware General Corporation Law* (Client Memorandum of Potter Anderson & Corroon LLP dated Feb. 20, 2009, on file with author) (noting that the amendment will permit corporations to fix a record date for voting separate from the record date for notice of the stockholder meeting, so as to enable corporations to fix a record date that is closer to the meeting date, and presumably more reflective of the stockholder base, than a record date that is as many as 60 days prior to the meeting date). European rules already provide that the record date shall not lie more than 30 days before the date of the general meeting and that at least eight days should elapse between the date for the convocation of the general meeting and the record date. Shareholders' Rights Directive, *supra* note 133, art. 8 (3).

[205] *See, e.g.*, Hu & Black *supra* note 2; Jonathan Cohen, *Negative Voting: Why It Destroys Shareholder Value and a Proposal to Prevent It*, 45 Harv. J. on Legis. 237 (2008); Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. Ill. L. Rev. 775 (2005); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 Vand. L. Rev. 129 (2009).

[206] Although the Commission raised the issue in a consultation in early 2007, apparently no further action has been taken since the publication in the summer of 2007 of a synthesis of the responses, *supra* note 187.

one vote would be socially beneficial, it can be questioned whether an absolute ban on empty voting would be. A study by Christoffersen et al. suggests vote trading may serve the socially beneficial role of incorporating more information in corporate votes.[207] A recent theoretical study by Brav and Mathews takes into account the possibility that the vote buyer and vote seller may not have coinciding interests. Their model suggests that strategic traders adjusting their economic ownership can improve overall efficiency, despite the fact that they will sometimes sell short after the record date and then vote to decrease firm value.[208]

Equally true, though, is that the question of whether there should be transparency merits separate consideration. Before answering this question, let us consider briefly the extent to which empty voting becomes transparent under existing disclosure requirements.

A. Existing Disclosure Requirements

European Commissioner McCreevy, announcing he would not pursue one share-one vote nor expand disclosure requirements, has stated that the Transparency Directive already contains ample provisions on transparency.[209] Remarkably, this statement appears to have been based, at least in part, on two studies acknowledging that the Directive offers limited insight and that investors believe increased transparency may be necessary.[210] The studies also point at the lack of transparency with regard to the decoupling of voting rights from economic ownership through

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[207] Susan E. K. Christoffersen, Christopher C. Geczy, David K. Musto & Adam V. Reed, *Vote Trading and Information Aggregation*, 62 J. Fin. 2897, 2927 (2007).

[208] Alon Brav & Richmond D. Mathews, *Empty Voting and Efficiency* (April 2008). AFA 2009 San Francisco Meetings Paper. Available at SSRN: http://ssrn.com/abstract=1108632.

[209] McCreevy, *supra* note 52.

[210] ECGI et al., *supra* note 48, Exhibit B, at 150 (merely observing that "[f]or a number of [control enhancing mechanisms], notification of the acquisition or disposal of major holdings is required when specified thresholds have been crossed"); European Commission, *supra* note 106, at 78 (noting that "[t]he requirements of the Transparency Directive do not impose disclosure of the measure of shareholder separation between investments and voting rights. (…) Such disclosure would however be valuable as it would allow to measure separation between the cash flow rights (e.g.; economic risks) and the voting rights in the case of shareholders holding a significant block") (although the Commission's impact assessment was published at a later date than the date Commissioner McCreevy held his speech, one would assume that he must have been aware of its main findings prior to deciding on whether or not to pursue one share-one vote); ECGI et al., *supra* note 48, at 94 ("[i]nvestors argue that transparency measures may be necessary in order to improve the level of information on the existence and impact of any of the control enhancing mechanisms").

securities lending and derivatives.[211]

Indeed, the Directive offers hardly any transparency with respect to cash flow rights, and even less with respect to empty voting. Acquiring a substantial capital interest *per se* does not trigger a disclosure obligation, contrary to the US.[212] The Directive also falls short of requiring disclosure of the number of shares held on the notification form, let alone arrangements affecting economic exposure.[213] The fact that cash flow rights did not need to be reported under the precursor of the Directive was already identified in 1997 as a major reason why it was difficult to measure the separation between ownership and control in European firms.[214] Unfortunately, the Directive has not changed this. Again, US rules go much further, especially for shareholders whose stake exceeds 10%, who are not only required to disclose the number of shares and options held but also other arrangements affecting their economic exposure.[215]

Despite the limited scope of the Directive's disclosure rules, the rules at the level of individual European countries may be tighter, given that the Directive allows this.[216] While individual countries have indeed imposed stricter disclosure requirements in many respects, they have not done so in respect of economic interests.[217] Only in a few European countries can a disclosure obligation be triggered

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211 ECGI et al., *supra* note 48, at 9 (noting that stock lending and derivatives would be worth studying, but that it is very difficult to do so partly due to a lack of transparency); European Commission, *supra* note 106, at 79 (noting that in response to decoupling major shareholders could be required to disclose to what extent and by what means they have reduced their economic risk). *See also* Brav et al. *supra* note 41 at 1748 (finding that in approximately 16.1% of the cases in their sample hedge funds report derivative positions in the target companies, that these are mostly securities with embedded option features issued by the target companies and not derivatives representing countervailing positions that offset the economic interests from the long positions, but noting that this information is likely incomplete given that disclosure is not mandatory).

212 Rule 13d-3 of the Exchange Act, 17 C.F.R. 240.13d-3.

213 The standard notification form published by the Commission merely acknowledges that the laws of individual Member States may require reporting not only of voting rights but also of shares held. *See also* CESR, *supra* note 179, at 29, 49 (stating that "CESR believes that that the inclusion of the number of shares should not be mandated," even though elsewhere in the document it is stated that "it is clear that the intention of the Transparency Directive is to impose ongoing obligations on shareholders in respect of acquisitions and disposals of both shares and voting rights").

214 Becht, *supra* note 8, at 87.

215 Exchange Act Rule 16a-1(a), 16a-2, 17 C.F.R. 240.16a-1(a), 16a-2 (2005). *But see* Hu & Black, *supra* note 2, at 873 (explaining that transparency is still limited).

216 Transparency Directive, *supra* note 10, art. 3 (1) (though only with respect to holders of shares in issuers for which they act as a "home Member State").

217 CESR, SUMMARY OF RESPONSES TO QUESTIONNAIRE ON TRANSPOSITION OF THE

both as a result of acquiring voting rights and as a result of acquiring shares.[218] Moreover, only in about half of European countries are notifying shareholders required to report the percentage of share capital held in addition to the percentage of voting rights held, while there is no mention of reporting pure economic interests.[219]

European countries have also taken divergent approaches with respect to securities lending. For example, in some European countries securities lending triggers a disclosure obligation on the part of both the borrower and the lender, while in others only on the part of the borrower.[220] Taken together, this means that in some European countries the market might be unaware of both the fact that the borrower has no economic interest and that the lender no longer has the voting rights initially reported.

A related question is whether the Market Abuse Directive requires disclosure of capital interests and hedging by insiders. Under this directive, a disclosure obligation is triggered in the case of transactions in the share or "derivatives or other financial instruments linked to them."[221] Moreover, the notification should include a description of such financial instruments.[222] These rules thus have a broader scope than the rules under the Transparency Directive – pretty much like US rules on insider trading do.[223] As such, they could provide inspiration for possible expansion of the Directive's disclosure obligations, the need for which becomes clear in the following section.

B. Understanding Why Empty Voting is Problematic

Using the taxonomy of the mechanisms through which ownership disclosure improves market efficiency and corporate governance as a framework for analysis, it

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TRANSPARENCY DIRECTIVE, CESR/08-514B (2008). *See also* European Commission, *supra* note 126.

218 SIMMONS & SIMMONS, DISCLOSURE OF SHARE OWNERSHIP IN LISTED COMPANIES: AN INTERNATIONAL LEGAL SURVEY, 18, 19, 25 (2004) (reporting that such rule exists in the Netherlands, Finland, and France).

219 CESR, *supra* note 217, at 4, 5.

220 *Id.* at 3.

221 Market Abuse Directive, *supra* note 94, art. 6 (4).

222 Commission Directive 2004/72/EC, *supra* note 153, art. 6 (3) (d).

223 Exchange Act Rule 16a-1(a), 16a-2, 17 C.F.R. 240.16a-1(a), 16a-2 (2005).

becomes clear that empty voting too severely undermines these mechanisms.[224] Empty voting can affect transparency of economic interests essentially in the same way as lack of transparency of conventional deviations from one share-one vote.[225] Indeed, the problem remains the same: the incentives of the shareholder who has less economic exposure than voting rights are distorted. In each case, transparency allows investors to anticipate the implications for share value.

With respect to empty voting, however, the market relies even more heavily on the Transparency Directive for information. Information on most conventional disproportionate mechanisms is provided by an array of sources, including company statutes and initial and ongoing issuer disclosure requirements.[226] This explains why the evidence suggests that the extent of private benefit extraction by controlling shareholders in dual-class firms is correctly anticipated; stock returns of such firms are not lower than those of single-class firms.[227] These sources, however, will typically fail to inform the market if a wedge between voting rights and cash flow rights is created through market instruments instead of institutional instruments, not for the long term but for a short term, and not by insiders but by outside investors, whose voting behavior may nonetheless determine the outcome of the voting process. What is needed in those cases is ad hoc disclosure by shareholders rather than initial or periodic disclosure by issuers. Hence the pivotal role of the Transparency Directive.

Perhaps even more importantly, disclosure of the potential of empty voting can facilitate enforcement. Transparency enables issuers, shareholders and regulators to respond to, or prevent, abusive instances of empty voting. If, for example, it becomes clear that a hedge fund with substantial voting rights but a negative net economic position is trying to block a shareholder resolution, this could spur the company or other shareholders into action, through litigation or otherwise. Moreover, the prospect of public scrutiny may discourage shareholders from engaging

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[224] Thus, the following analysis only offers insight into the adverse effects caused by empty voting through its impact on transparency. It would fall outside the scope of this article to discuss the possible adverse effects caused by empty voting through its impact on other aspects of corporate governance. There is an emerging body of literature addressing this broader question: *see* references *supra* note 205.

[225] *See supra* notes 44 - 56 and accompanying text.

[226] For an overview, *see* ECGI et al., *supra* note 48, at 17; European Commission, *supra* note 106 at 70.

[227] Burkart & Lee *supra* note 52, at 34, 35.

in empty voting in the first place.[228] The European Commission has already applied this line of reasoning with respect to sovereign wealth funds, which raise concerns that, in some respects, are similar to concerns over empty voters.[229]

IV. POLICY IMPLICATIONS

From the preceding analysis it becomes clear that, as a general matter, policymakers contemplating how to respond to hidden ownership and empty voting should not focus only on the most obvious problems caused by these phenomena, such as malfunctioning of the market for corporate control. Instead, they should take into account the whole range of adverse effects on market efficiency and corporate governance, as described in this paper.

This observation should be particularly relevant to the European Commission, which is currently evaluating the European ownership disclosure regime, embodied in the Transparency Directive. The European Securities Markets Expert Group has suggested that informing market participants of significant changes in the voting structure is the Directive's "exclusive" reason for being.[230] But this paper has shown that ownership disclosure can improve market efficiency and corporate governance through various mechanisms. This means that the Commission should assess the extent to which each of these mechanisms are functioning adequately, taking into account their relative significance and interaction.[231]

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[228] Stephen M. Bainbridge, *Sunlight the Best Disinfectant for Hedge Fund Empty Voting*, Examiner.com, Jan. 30, 2007. Available at http://www.examiner.com.

[229] *A Common European Approach to Sovereign Wealth Fund - Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions*, at 4, 9 COM (2008) 115 final (Feb. 27, 2008) (stating that "there is unease that – whatever the original motivation – [sovereign wealth fund] investment in certain sectors could be used for ends other than for maximising return," that "[t]ransparency provides a disciplinary effect on the management of sovereign assets" and that "[t]ransparency practices that could be considered would include: Annual disclosure of investment positions and asset allocation; (…) [e]xercise of ownership rights and (…) [d]isclosure of the use of leverage").

[230] ESME, *supra* note 3, at 2. According to the ESME, the Directive has other "acceptable" effects, but these effects are considered secondary and "must not condition the shape and scope of the disclosure requirements under the [Directive]."

[231] This is not to suggest that ensuring transparency of the voting structure is not the primary objective of the disclosure regime. It is. In 1997, the ECGN concluded that the level of transparency was not enough to guarantee that those who had ultimate control could be properly identified; Becht, *supra* note 8, at 90. In 2002, the High Level Group of Company Law Experts emphasized the need for more transparency of the governance structures of groups of companies, in particular the ownership

Moreover, the analysis suggests that the Transparency Directive in its present form does not effectively prevent hidden ownership and that this severely undermines the mechanisms through which ownership disclosure improves market efficiency and corporate governance. This strongly suggests that the Commission should consider expanding the scope of the disclosure rules.[232] Yet, while most of this paper has been devoted to discussing the benefits of disclosure, policymakers should duly take into account the potential costs of increased disclosure – beyond incremental compliance costs.

By increasing market impact cost, for example, disclosure could reduce hedge funds' incentives to incur the costs of searching for fundamental information and of engaging in activism.[233] Given that preliminary findings suggest hedge fund activism benefits existing shareholders,[234] regulators should caution not to unduly limit hedge funds' ability to engage in activism.[235] Fear that disclosure will prompt replication of trading strategies may also adversely affect liquidity. AIMA, which represents the hedge fund industry, has explicitly voiced this concern.[236]

Still another cost could result from management of listed companies responding to information on stakebuilding through equity derivatives in a way that serves its own interest rather than the interest of the company and its shareholders. The mounting of defensive measures, for example, could adversely impact the market for corporate control.[237] In the US, some issuers have already changed their shareholder

structure of pyramids; High Level Group, *supra* note 85, at 96, 98. The evaluation should therefore first and foremost be concerned with determining whether the Directive has sufficiently improved this situation.

[232] For detailed proposals on how to expand the UK disclosure rules, *see* FSA, *supra* note 170; with respect to the US disclosure rules, *see* Hu & Black, *supra* note 2, at 864; WACHTELL, LIPTON, ROSEN & KATZ, BENEFICIAL OWNERSHIP OF EQUITY DERIVATIVES AND SHORT POSITIONS – A MODEST PROPOSAL TO BRING THE 13D REPORTING SYSTEM INTO THE 21ST CENTURY (Client Memorandum dated March 3, 2008, on file with author).

[233] *See* Hu & Black, *supra* note 2, at 841.

[234] Brav et al. *supra* note 41; Klein & Zur, *supra* note 41.

[235] This does not only have implications for determining the optimal scope of the disclosure rules but also, for example, for determining the optimal period of time allowed between crossing the reporting threshold and filing the notification form.

[236] Letter from the Alternative Investment Management Association (AIMA) to the FSA dated Feb. 12, 2008 (on file with author) (noting that disclosure would leave trading strategies "open to replication by those who have not expended the resources to conduct their own diligent research and investment analysis").

[237] *See* Hu & Black, *supra* note 2, at 841.

rights plans to explicitly include derivatives when calculating the level of beneficial ownership that triggers the poison pill.[238] Issuers could also respond by filing lawsuits alleging inaccurate disclosures, the accuracy of which becomes increasingly contestable as disclosure obligations become more complex. Such litigation risk could not only deter potential bidders but also chill shareholder activism.[239]

Indeed, the fact that issuers are among the loudest proponents of increased transparency should caution policymakers to carefully examine their motivations.[240] This is of particular concern given that the current financial crisis may have affected the political economy in such a way as to make policymakers even more responsive to issuers' concerns over hedge fund activity.[241] A case in point is the restriction of short selling, the efficacy of which remains controversial.[242]

Similarly, the analysis has shown that the Transparency Directive sheds virtually no light on empty voting and that empty voting severely undermines the mechanisms through which ownership disclosure improves market efficiency and corporate governance. Again, this strongly suggests the European Commission should consider expanding the scope of the disclosure rules, while being mindful of the potential costs and unintended consequences.

One such unintended consequence could be an overflow of information. With respect to securities lending, the European Securities Markets Expert Group has expressed concern that too much disclosure could be misleading by making material information less easy to identify, and could adversely affect liquidity.[243] Moreover, if and to the extent empty voting enhances efficiency, as some research suggests, disclosure could improve efficiency but also reduce efficiency, depending on the

[238] Mara Lemos-Stein, *Poison Pills Target Derivatives*, WALL ST. J., June 18, 2008.

[239] *See supra* note 126 and accompanying text.

[240] *See supra* note 123 and accompanying text. For an early explanation of mandatory disclosure rules from a public choice theory perspective, *see* Macey & Netter, *supra* note 39, at 157, 158 (arguing that narrow interest-group concerns (in particular those of incumbent management) motivated the legislative process that produced the US ownership disclosure rules).

[241] *Cf.* McCahery & Vermeulen, *supra* note 126, at 541, 555 (identifying protection of incumbent management as one objective of ownership disclosure rules, and noting that the credit squeeze has slowed down hedge fund activity and resulted in intense scrutiny from regulators, policymakers and the judiciary).

[242] For a survey of the literature, *see* FSA, *supra* note 74, Annex I.

[243] ESME, *supra* note 3, at 7.

circumstances.[244] This reminds us that any measure designed to address empty voting requires a thorough understanding of this phenomenon. Ironically, transparency may be exactly what we need to obtain such understanding.[245]

In assessing the costs and benefits of increased disclosure, policymakers should also be mindful of the limitations of the law. As two prominent scholars have put it,

> "the drafters of the disclosure rules are usually lagging behind market developments in ways of acquiring interests in shares without triggering the disclosure requirement, which developments go some way to mitigate the adverse implications of the rules for acquirers."[246]

Similarly, the chief lobbyist of the German hedge fund industry was recently quoted as saying that he saw no need for a regulatory clampdown of equity derivatives in response to cases like *Schaeffler* because "[n]ew types of derivatives or trading techniques would emerge that were not subject to this regulation."[247] These observations fit within a broader theory that law is inherently incomplete due to the fact that lawmakers are unable to foresee all future contingencies.[248] The originators of this theory highlight the role for regulators as proactive law enforcers with an ability to adapt rules flexibly over time, an issue that will be revisited below. The inherent incompleteness of law also argues for a principle based approach rather than a legalistic approach. With this in mind, the FSA has extended the scope of its new disclosure rules to any financial instruments that have "a similar economic effect" as financial instruments that would trigger disclosure.[249]

Finally, policymakers should assess whether existing rules are adequately enforced. As with any ad hoc disclosure obligation, because recipients do not expect particular disclosures in advance, vigorous enforcement is key to ensure compliance.[250] Focus

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[244] Brav & Mathews, *supra* note 208, at 29.

[245] *See* Hu & Black, *supra* note 2, at 886.

[246] PAUL DAVIES & KLAUS HOPT, CONTROL TRANSACTIONS, in: THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (forthcoming 2009) (manuscript at 11, on file with author).

[247] Christiaan Hetzner, *VW Shares Halve As Porsche Eases Short Squeeze*, INT'L HERALD TRIBUNE, Oct. 29, 2008.

[248] Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. Int'l L. & Pol. 931 (2002-2003).

[249] FSA (2009), *supra* note 170, at 6, 7 and DTR 5.3.1 R 1 (b) (ii) (in force as of June 1, 2009).

[250] JOHN ARMOUR, HENRY HANSMANN & REINIER KRAAKMAN, AGENCY PROBLEMS AND LEGAL

on enforcement by the European Commission is especially warranted in view of the recent accession of a host of Eastern European countries to the European Union. Although most of these countries had adopted a 5% disclosure threshold by 2002, an empirical study found that in most of these countries the identity of the ultimate owner was still undisclosed due to the laxity in regulation or enforcement of disclosure.[251] A related study found substantial variations across Eastern European countries in what companies disclose about their corporate governance arrangements, and concluded that while accession to the European Union has been successful in transforming the laws on the books in these countries, implementation at firm level is still lagging.[252]

CONCLUSION

This paper has explored the fundamental question of why we have ownership disclosure rules. Using the European ownership disclosure regime as an example, the paper has first identified two main objectives of ownership disclosure rules: improving market efficiency and corporate governance. The paper has shown that mandatory ownership disclosure can perform these tasks through various mechanisms. Disclosure of the voting structure as well as changes in the voting structure may inform share prices. The same applies for disclosure of capital movements, which can create transparency of economic interests of shareholders, of trading interest and of the size of the free float. Moreover, mandatory ownership may improve corporate governance, by enabling enforcement and by providing a communication tool.

STRATEGIES, in: THE ANATOMY OF CORPORATE LAW, *supra* note 246, at 14. *See also* Siems, *supra* note 135, at 142 (noting that the enforceability of ownership disclosure provisions is endangered by the fact that the shareholders' register does not identify holders of bearer shares or fiduciary holdings).

[251] E. BERGLÖF & A. PAJUSTE, EMERGING OWNERS, ECLIPSING MARKETS? CORPORATE GOVERNANCE IN CENTRAL AND EASTERN EUROPE, in: CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY (P.K. Cornelius & B. Kogut eds., 2003), at 267, 286, 291. *See also* John C. Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229 (2007) (finding a disparity in enforcement intensity between common law and civil law countries).

[252] Erik Berglöf & Anete Pajuste, *What Do Firms Disclose and Why? Enforcing Corporate Governance and Transparency in Central and Eastern Europe*, 21 Oxford Rev. Econ. Pol. 178, 180 (2005). *See also* Yuan Ding, Ole-Kristian Hope & Hannu Schadewitz, *Firm-Level Transparency in the Former East Bloc: Empirical Evidence from the Baltic Region* (manuscript at 15, available at SSRN: http://ssrn.com/abstract=1098193) (finding that in 2004, Baltic firms disclosed significantly less ownership information than Nordic firms).

The paper has further shown that the use of equity derivatives to exert undisclosed influence on issuers or to facilitate creeping acquisitions ("hidden ownership") severely undermines the mechanisms through which ownership disclosure improves market efficiency and corporate governance. The same is true for the use of equity derivatives, securities lending or short selling to hedge economic exposure while retaining full voting rights ("empty voting"). Although more than ten years have passed since the seminal study of ownership disclosure in Europe, the key question raised in that study remains the same: is the definition of control sufficiently narrow to pin down the ultimate controlling agent?[253] This paper has argued that financial innovation causes the answer to be negative, which suggests that expansion of the rules is warranted.

Three issues are not addressed in this paper, but nonetheless merit careful consideration. First, while the paper has identified benefits as well as costs of disclosure, it does not offer an exhaustive cost-benefit analysis. Indeed, by complicating the taxonomy the paper may have presented policymakers with more questions than answers. But at least this should enable an evaluation of the disclosure regime that takes into account all relevant aspects.

Second, the paper has largely assumed that the voting structure determines who controls the company. But this is a simplification of reality. Shareholders and other stakeholders can exert influence over issuers in a variety of ways, which explains why accounting and antitrust provisions typically use broader, more substantive concepts of control. This nuance has gained weight as governments have responded to the current financial crisis by injecting huge amounts of capital in troubled financial institutions. Late 2008, for example, the Dutch State injected EUR 10 billion in ING, one of Europe's largest financial institutions.[254] It did so through the purchase of non-voting core Tier-1 securities. As part of the deal, the State obtained the right to nominate two members for ING's supervisory board with special approval rights. In some respects, the State can now exert more influence over ING than any shareholder can. Yet it does not hold a single share and its influence remains invisible if we focus

[253] Becht, *supra* note 8, at 90.

[254] Press Release, ING, ING to Strengthen Core Capital by EUR 10 Billion (Oct. 19, 2008) (on file with author).

only on voting rights. This shows the limitations of using voting power as a proxy for control and represents an interesting avenue for further research.

Third and finally, while the paper suggests that legislative action could be conducive to realizing the objectives of the European ownership disclosure regime – improving market efficiency and corporate governance -, it does not address the question of whether action should be taken at European level or whether this should be left to individual European countries. The fact that the regime provides for minimum harmonization raises the question of whether it would be socially more beneficial to rely on regulatory competition between countries. The swiftness with which the UK has expanded its disclosure rules suggests this might be a fruitful approach. Indeed, its rapid response may be seen as an example of what professor Deakin refers to as "efficient evolutionary adaptation of systems to changing environmental conditions," facilitated by a directive that provides the conditions for local diversity and thus enables search and learning processes.[255]

While it goes beyond the scope of this paper to address this question, two preliminary remarks can be made, taking into account the ambition of creating a single European market that inspired the European Commission to establish the disclosure regime. First, minimum harmonization presupposes that mere implementation at national level of the European rules creates sufficient transparency. Yet this paper has shown the floor is currently set too low, which may deter cross-border investment.[256] Second, the current level of divergence may deter cross-border investment by institutional investors, who are faced with no less than 27 different ownership disclosure regimes they potentially have to comply with.[257] This raises concerns the Commission should duly take into account when determining its future policy on ownership disclosure.

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[255] Simon Deakin, *Two Types of Regulatory Competition: Competitive Federalism Versus Reflexive Harmonisation. A Law and Economics Perspective on Centros*, 2 CYELS 231, 260 (1999). On regulatory competition in EU securities law, *see, generally,* Ferran, *supra* note 13, at 50-57; Luca Enriques & Tobias H. Troeger, *Issuer Choice in Europe*, 67 Cambridge L. J. 521 (2008); European Commission (2008), *supra* note 126; Mathias M. Siems, *The Foundations of Securities Law*, 20 European Bus. L. Rev. 141 (2009).

[256] *See* Christian Leuz, Karl V. Lins & Francis E. Warnock, *Do Foreigners Invest Less in Poorly Governed Firms?*, Rev. Fin. Stud. (forthcoming).

[257] *See* ESME, *supra* note 3, at 5; European Commission *supra* note 187, at 14; European Commission, *supra* note 126, at 4, 13.