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 Article aims to answer these fundamental questions, using the European disclosure regime as an example. First, the Article identifies two main objectives of ownership disclosure: improving market efficiency and corporate governance. Next, the Article 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.

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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 an 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.[3] The case for mandatory ownership disclosure has also received remarkably little attention in 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 is such information important, and to whom?

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

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[1] Richard Milne, *Hedge Funds Hit as Porsche Moves on VW*, FIN. TIMES, Oct. 27, 2008. For a discussion of this case, see *infra* note 201 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 Univ. 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 et al., *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).

yielded by this Article can be applied universally and should be of interest to scholars and policymakers around the globe, including the U.S. Securities and Exchange Commission (SEC).

The Article is structured as follows. Part I identifies two main objectives of ownership disclosure rules: improving market efficiency and corporate governance. Next, it explores the different mechanisms through which ownership disclosure performs these tasks. This Part thus focuses on the potential benefits of disclosure rather than the costs, some of which will be discussed later in the Article. The resulting taxonomy sets the stage for a systematic analysis of hidden ownership and empty voting.

Part II describes some recent high-profile cases that have occurred in Europe and in the U.S. and that illustrate the dramatic effects of hidden ownership. Next, it analyzes the extent to which this phenomenon is captured by existing rules under the disclosure regime. The analysis suggests it is not, at least not effectively. Finally, this Part demonstrates how hidden ownership undermines the mechanisms through which ownership disclosure improves market efficiency and corporate governance. Part III offers a similar analysis of empty voting. Together, Parts II and III enable a better understanding of why hidden ownership and empty voting are so problematic.

Part IV discusses policy implications. 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 Article. 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 Part.

The Article concludes by summarizing the main findings and 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 im-

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[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 ra-

proved 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 aim, 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

> . . . 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 fur-

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tionale 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. For an empirical analysis of the evolution of ownership disclosure rules across countries, see Michael C. Schouten & Mathias M. Siems, *The Evolution of Ownership Disclosure Rules Across Countries* (2009), *available at* http://ssrn.com/paper=1434144.

7 *See, e.g.*, THE CONTROL OF CORPORATE EUROPE (Fabrizio Barca & Marco Becht eds., Oxford Univ. 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.* at 2.

12 *Id.* at 18.

ther detail below, it can be inferred that the main objectives of the European ownership disclosure regime are (1) improving market efficiency and (2) improving corporate governance.[13] The following sections explore 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 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

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[13] *See also* EILIS FERRAN, BUILDING AN EU SECURITIES MARKET 127, 130 (Cambridge University Press 2004) (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 Article 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. 237, 253 (2009). *See also* Gaëtane Schaeken Willemaers, THE EC ISSUER-DISCLOSURE REGIME: RETHINKING THE OBJECTIVES TO SUGGEST SOME REGULATORY IMPLICATIONS - PLIOMPARATIVE AND INTERDISCIPLINARY APPROACH (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 261 (Klaus Hopt & Eddy Wymeersch eds., Butterworths 1991) (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 Article discuss 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 Article).

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

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

[16] *Id*. at 344.

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," or 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 supports the view 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 argues 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 *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 fol-

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[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 Article that a market solution is unlikely to produce a socially desirable level of ownership disclosure. For a discussion of potential costs of mandatory ownership disclosure, *see infra* note 244 and accompanying text.

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

[22] *See infra* note 266 and accompanying text.

lowing classic example.

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 overmonitoring, which may discourage management from showing initiative.[28] In practice, the 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

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[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 112-16 (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. FIN. 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. 1103 (1994).

[26] *See, e.g.,* Marc Goergen et al., *Do UK Institutional Shareholders Monitor Their Investee Firms?*, 8 J. CORP. LAW STUD. 3 (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 of the Firm*, 112 Q. J. ECON. 693 (1997).

[29] *See, e.g.,* Henrik Cronqvist & Rudiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. FIN. STUD.3941 (2009).

[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. FIN. 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 FIN. 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

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 explains why securities laws typically require disclosure of the ownership structure in the prospectus.[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 probabil-

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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. FIN. 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. L. 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 et al., *supra* note 33; John J. McConnell et al., *Changes in Insider Ownership and Changes in the Market Value of the Firm*, 14 J. CORP. FIN. 92 (2008); Stijn Claessens et al., *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), *available at*: http://ssrn.com/abstract=1102763.

[34] *See* 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); Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 684 (2008) (noting that "[f]rom an economic standpoint, share pricing will be more efficient if investors know what major investors are doing"); 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).

[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.

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

ity of a control contest.[37]

b. Changes in the Voting Structure

If information on corporate control is fundamental information, then so must be information on a potential *shift* in corporate control. Indeed, the rationale of the U.S. 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 information would enable corporations, their shareholders and potential investors to evaluate the possible effects of a change in substantial shareholdings.[39]

A potential shift in corporate 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 competitor, could signal an increased probability of a control contest. This increased probability should increase the value of the share, a prediction supported by empirical evidence.[40] 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]

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[37] *Id*. at 1048.

[38] GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 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). *See also* Hu & Black, *supra* note 34, at 684 (noting that "[f]rom an economic standpoint, share pricing will be more efficient if investors . . . have advance notice of possible changes in control."). *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) (for a discussion of public choice theory, *see infra* note 132 and accompanying text and *infra* note 252 and accompanying text).

[40] *See, e.g.*, W.H. Mikkelson & R.S. Ruback, *An Empirical Analysis of the Interfirm Equity Investment Process*, 44 J. FIN. ECON. 14, 523, 534, 535 (1985) (measuring the announcement effects of U.S. 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%, with average two-day initial announcement prediction error).

[41] Alon Brav et al., *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

Conversely, the exit of a blockholder 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 result is consistent with the view that monitoring by a blockholder increases shareholder value.[42] In sum, the market's response to the shift in control will depend on the past behavior of the exiting blockholder and the expected behavior of the incoming blockholder.

2. Transparency of Capital Movements

Disclosure of major shareholdings, according to the Transparency Directive, 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 a disclosure obligation 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 (i.e., cash flow rights) 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 cash flow rights.

According to the Commission, disclosure of cash flow rights 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 per-

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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*, 92 J. FIN. ECON. 362 (2009).

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

[43] Transparency Directive, *supra* note 10, at 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 (Mar. 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 Article assumes that is not the case.

formance, business strategy and earnings."[46] Such disclosure, however, was only found necessary in case of deviations from one share-one vote.[47] Studies show that European firms frequently deviate from one share-one vote, including by issuing shares with multiple voting rights or non-voting preference shares.[48] Apparently, 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 bears 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

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[46] *Id*. at 18.

[47] *Id*. at 44 (stating 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"). 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 et al., *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. FIN. ECON. 365, 389 (2002); REPORT ON THE PROPORTIONALITY PRINCIPLE IN THE EUROPEAN UNION, ECGI, ISS EUROPE AND SHEARMAN & STERLING (2007), at 24, 25.

[49] Lucian A. Bebchuk et al., *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., Univ. of Chicago Press 2000), at 20.

[50] Sanford Grossman & Oliver Hart, *One Share-One Vote and the Market for Corporate Control*, 20 J. FIN. 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

encourage private benefit extraction, they also provide a cheaper way to monitor 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 between voting rights and cash flow rights, 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 result 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.

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 eq-

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REV. FIN. 1 (2008) and Renee B. Adams & Daniel Ferreira, *One Share, One Vote: The Empirical Evidence* 12 REV. FIN. 51 (2008).

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 *See* Arman Khachaturyan, *Trapped in Delusions: Democracy, Fairness and the One-Share-One-Vote Rule in the European Union*, 8 EUROPEAN BUS. ORG. L. REV. 335, 357 (2007).

56 *See* Rafael La Porta et al., *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. FIN. 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).

uity 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. A trader with the resources to gather and analyze such information may conclude that the share is overvalued or undervalued and capitalize on this insight by selling or buying shares, respectively.[58]

Once the trader 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 that the trading against the market signals the presence of fundamental information and, therefore, start trading in the same direction.[60]

Price decoding thus occurs when the attention of other traders is captured by trades that signal the presence of fundamental information because they are conducted against an unusual price. Yet, trades can also signal the presence of fundamental information because of other unusual features. Such features include 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.[61] If other traders become convinced that the trades are driven by fundamental information, they will start mimicking the informed trader. As a result, the process whereby the fundamental information is impounded in the share price is accelerated, through a mechanism referred to as *trade decoding*.[62]

How do uninformed traders become aware of such unusual trades? Potential sources of information 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

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[57] LARRY HARRIS, TRADING & EXCHANGES 240 (Oxford Univ. 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] *See* Aslihan Bozcuk & M. Ameziane Lasfer, *The Information Content of Institutional Trades on the London Stock Exchange*, 40 J. FIN. QUANT. ANAL. 621, 638 (2005); David Easley & Maureen O'Hara, *Price, Trade Size, and Information in Securities Markets*, 19 J. FIN. ECON. 69 (1987); David Hirshleifer & Siew Hong Teoh, *Herd Behaviour and Cascading in Capital Markets: A Review and Synthesis*, 9 EUR. FIN. MGMT. 25, 48 (2003).

[62] *Id*.

[63] Albert S. Kyle, *Continuous Auction and Insider Trading*, 53 ECONOMETRICA 1315

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 may be driven by a need for liquidity or a desire to rebalance the portfolio. But it may also be driven by the possession of fundamental information. Thus, the market may interpret the sale as a signal that the share is overvalued.

From this perspective, whether there is marginal value in mandating disclosure of major transactions depends on how rapidly the fundamental information conveyed by such transactions is impounded in the share price. Clearly, there would be little point in mandating disclosure if the fundamental information would become fully reflected in the share price even *before* the disclosure is made. But the evidence suggests that, generally, this is not the case. Empirical studies of announcement effects show abnormal returns on both transaction dates and announcement dates, even if there is no overlap between the two.[65] The impact of disclosure is nicely illustrated by the following chart, which shows that abnormal returns surrounding major transactions by hedge funds see a jump of about 2.0% on the filing day and the following day.[66]

(1985); Sugato Chakravarty, *Stealth-Trading: Which Traders' Trades Move Stock Prices?* 61 J. FIN. ECON. 289 (2001). The purpose of iceberg orders is illustrated by the explanation of the term offered by *Investopedia.com*: "[w]hen large participants, such as institutional investors, need to buy and sell large amounts of securities for their portfolios, they can divide their large orders into smaller parts so that the public sees only a small portion of the order at a time – just as the 'tip of the iceberg' is the only visible portion of a huge mass of ice. By hiding its large size, the iceberg order reduces the price movements caused by substantial changes in a stock's supply and demand.," http://www.investopedia.com/terms/i/icebergorder.asp.

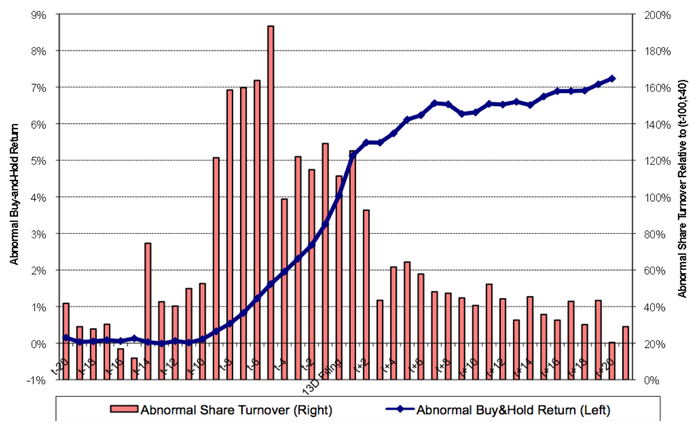
[64] *See* Hans A. Degryse et al., *Shedding Light on Dark Liquidity Pools* (TILEC Discussion Paper No. 2008-039, 2008) (manuscript at 3, 6), *available at* http://ssrn.com/abstract=1303482. Not surprisingly, dark pools are increasingly raising transparency concerns. *See* Jeremy Grant, *Europe to Review 'Dark Pool' Trading*, FIN. TIMES, June 22, 2009, http://www.ft.com/cms/s/0/e5588350-5f45-11de-93d1-00144feabdc0.html?nclick_check=1.

[65] FSA, *Disclosure of Contracts for Differences, Consultation and Draft Handbook Text* (CP 07/20) (2007), 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 documenting statistically significant abnormal returns of 0.36% over the [-1, +1] window around the disclosure date). In annex 2 of the same document, the FSA surveys the finance literature, and concludes that there can be benefits from disclosure in relation to price efficiency.

[66] Brav et al., *supra* note 41, at 1755. Brav et al. note that for a subsample of events for which the time of the Schedule 13D filing coincides with the first public announcement of activism in which a hedge fund describes a new and explicit agenda in the Schedule 13D beyond a general statement of maximizing shareholder value on the filing, the magnitude of abnormal returns is even higher, with average abnormal returns of 8.4% during the (–20, 20) window. *Id.* at 1756.

FIGURE 1

BUY-AND-HOLD ABNORMAL RETURN AROUND THE FILING OF SCHEDULE 13DS



Source: Brav at et al. (2008)[67]

The abnormal returns could, of course, be the mere consequence of the control implications of the transactions concerned. In fact, this is the most likely explanation for the abnormal returns shown in Figure 1, which focuses on filings by activist hedge funds.[68] These transactions do not necessarily convey *underlying* fundamental information; rather, the transactions themselves constitute fundamental information. So we need to take a closer look at the evidence and filter out transactions with control implications. This is challenging, 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.

U.S. 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.[69] 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 filings of both active and passive

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[67] *Id.* at 1756. The solid line (left axis) plots the average buy-and-hold return around the Schedule 13D filing, in excess of the buy-and-hold return of the value-weight market, from 20 days prior the Schedule 13D file date to 20 days afterward. The bars (right axis) plot the increase (in percentage points) in the share trading turnover during the same time window compared to the average turnover rate during the preceding (–100, –40) event window.

[68] *See* Brav et al., *supra* note 41 and accompanying text.

[69] Exchange Act Rule 13d-1(a), 17 C.F.R. § 240.13d-1 (2010). 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 164.

holdings produce abnormal returns, even though the returns from the latter cases are smaller.[70]

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 and to what extent they are driven by value implications. Empirical studies measuring the announcement effects of transactions by investors who are relatively likely to be perceived as informed traders document abnormal returns, though again, they are modest.[71]

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 of this reasoning 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.[72] There is some evidence that disclosure of short sales triggers a significant market response.[73] This suggests that disclosure accelerates the rate at which fundamental information is impounded in share prices.[74]

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[70] Christopher Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 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).

[71] Bozcuk & Lasfer, *supra* note 61, 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. MGMT 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)).

[72] *See* Ekkehart Boehmer et al., *Which Shorts are Informed?*, 63 J. FIN. 491 (2008).

[73] Michael J. Aitken et al., *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).

[74] *Id.* at 2222.

For this reason, a number of countries require disclosure of short positions to the market.[75] Their number has increased significantly over the recent years, as regulators across the globe have responded to the recent financial crisis by tightening disclosure requirements.[76] To be sure, these measures are primarily driven by concerns about market abuse,[77] which is why some countries only require short positions to be reported to the regulator.[78] Nevertheless, informational benefits are also cited as a reason for requiring disclosure.[79]

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.[80] Thus, the FSA recently warned that disclosure of short sales may cause herd behavior, triggering excessive sales and price declines.[81]

Another reason for caution is that by reducing the rewards of trading on

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[75] *See* IOSCO, *Report on Transparency of Short Selling* 14, 21 (2003) (noting that "[a] number of countries take the view that there is value in the disclosure of short selling to market users and provide for transparency in their short selling regimes," and providing an overview of such countries).

[76] *See, e.g.*, FSA, *Short Selling (No 4) Instrument 2008/60* (2008). For an overview of reporting obligations imposed by various regulators, see International Organization of Securities Commissions (IOSCO), *Regulation of Short Selling - Consultation Report* 25 (2009); Committee of European Securities Regulators (CESR), *Measures adopted by CESR Members on Short Selling* (2009).

[77] *See infra* note 204 and accompanying text.

[78] *See* IOSCO, *supra* note 75, at 25.

[79] *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); CESR, *CESR Proposal for a Pan-European Short Selling Disclosure Regime* 5 (proposing a pan-European system for public disclosure of short sales and noting that "facilitating ready access to information on short selling would provide informational benefits to the market, improving insight into market dynamics and making available important information to assist price discovery").

[80] *See* FSA, *The Turner Review: A regulatory response to the global banking crisis* 40, 42 (2009) (noting that "[i]n the face of the worst financial crisis for a century, however, the assumptions of efficient market theory have been subject to increasingly effective criticism," and that "the acceptance that financial markets are inherently susceptible to irrational momentum effects does imply that regulatory approaches should be based on striking a balance between the benefits of market completion and market liquidity and the potential disadvantages which may arise from inherent instabilities in liquid markets"); Emilios Avgouleas, *What Future for Disclosure as a Regulatory Technique? Lessons from the Global Financial Crisis and Beyond* (2009), *available at* http://ssrn.com/paper=1369004. *But see* Hirshleifer & Teoh, *supra* note 61, at 26, 52 (noting that practitioners and the media tend to conclude too easily that there is irrational herding.)

[81] FSA, *Temporary Short Selling Measures*, CP09/1, 10, 11 (2009); *see also* FSA, *supra* note 79, at 25; IOSCO, *supra* note 75, at 15 (noting that "general trading data often reflects no more than short-term technical adjustments and could be wrongly interpreted").

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."[82] Moreover, investors who are reluctant to reveal their trading strategies may limit their trading activity to avoid triggering disclosure, which could adversely affect liquidity.[83] 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, i.e. the part of the total number of outstanding shares that is actually available for trading. 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.[84]

First, consider the link between free float and liquidity, that is, the ability to quickly trade large size at low cost.[85] 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.[86] 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.[87]

The function of disclosure of major shareholdings, then, would be to enable

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[82] Sanford Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 405 (1980); *see also* Henry T. C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUROPEAN. FIN. MGMT. 663, 671 (2008) (describing the different effects of disclosure rules and noting that "it is unclear, either theoretically or empirically, which disclosure rules are optimal.")

[83] 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*, FIN. TIMES, Jan. 7, 2008, *available at* http://www.ft.com/cms/3cd7b992-dc84-11dd-a2a9-000077b07658.html.

[84] Tweede Kamer der Staten-Generaal [Dutch House of Representatives], Regels betreffende de melding van zeggenschap en kapitaalbelang in, alsmede de melding van het geplaatste kapitaal van ter beurze genoteerde vennootschappen (Wet melding zeggenschap en kapitaalbelang in ter beurze genoteerde vennootschappen) [Explanatory Memorandum to Dutch ownership disclosure rules], Kamerstukken II, 2002–2003, 28 985, no. 3, at 3.

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

[86] Kalok Chan et al., *Free Float and Market Liquidity: A Study of Hong Kong Government Intervention*, 27 J. FIN. RES. 179, 181 (2004).

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

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 answer 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 anticipate agency costs. This may explain why a recent survey among institutional investors shows that they consider such transparency important for their investment decisions.[88] Yet another explanation is that they consider transparency important because it can play an active role in *reducing* those costs.[89] Indeed, there is a substantial body of literature discussing mandatory disclosure as a means to address agency problems.[90]

Agency problems and the challenge to mitigate resulting 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.[91] The European 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 is-

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[88] Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors* 38, 50 (ECGI Working Paper Series in Finance, Working Paper No. 235, 2009), *available at* http://ssrn.com/paper=1331390.

[89] *Id.* at 15.

[90] *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.

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

> suers 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].[92]

In a similar vein, one of the aims of the Transparency Directive is to "enhance effective control of share issuers" by mandating ownership disclosure.[93] 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 Reinier Kraakman, disclosure can facilitate enforcement insofar as it "discourages opportunism in its own right" and "permits other legal controls that deter self-dealing decisions by corporate insiders."[94] 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.[95] In these firms, there is not a problem of "strong managers, weak owners" but rather of "strong blockholders, weak owners."[96] Because of the potential of private benefit extraction by blockholders and the resulting need for monitoring of their behavior, disclosure of major holdings is particularly important for these firms.[97] Three 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 U.S. law, holders of

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[92] Commission Recommendation 2004/913/EC of 14 Dec. 2004, Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies, § 3, 2004 O.J. (L 385) 55; *see also* § 9.

[93] Transparency Directive, *supra* note 10, § 18.

[94] Reinier Kraakman, *Disclosure and Corporate Governance: An Overview Essay*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 96 (Guido Ferrarini et al. eds., 2004). 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.

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

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

[97] *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).

a 10% stake are deemed to possess insider information, and their trading activity is therefore subject to stringent disclosure requirements.[98] 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."[99]

Today, the primary instrument to prevent this is the European Market Abuse Directive, which contains rules aimed at safeguarding market integrity.[100] The 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, albeit to a modest extent, given that subsequent transactions will not have to be disclosed unless they cause the crossing of one of the relevant thresholds that trigger a disclosure obligation. Disclosure may also prevent those whose interests are exposed from engaging in market abuse in the first place, consistent with the notion that sunlight is the best disinfectant.[101]

Second, disclosure of the identity of the person who ultimately controls the firm makes it easier to detect diversion of corporate assets.[102] Such diversion may occur, for example, through related party transactions that are not conducted at arms' length (tunneling). To be sure, in many jurisdictions, issuer disclosure rules already require disclosure of related party transactions. But at least in Europe, these rules only require periodic disclosure.[103] What is needed is some degree of ex ante disclosure.[104] This alerts outsiders to potential conflicts of interest, which may induce them to monitor more intensely. This, in turn, may discourage the controlling shareholder from engaging in tunneling in the first place. In spite of these benefits, research suggests that continental European countries still have relatively few ex ante disclosure requirements.[105] Particularly for those countries, ownership disclosure may consti-

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

99 European Commission, *supra* note 6, at 2.

100 Directive 2003/6/EC of 28 Jan. 2003, On Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 096) 16 [hereinafter Market Abuse Directive].

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

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

103 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.

104 *See* Black, *supra* note 34, at 1588 (noting that insiders have an incentive to disguise their share ownership in a company, and other companies that the first company deals with, in order to conceal their influence, and thus the self-dealing nature of a transaction); European Corporate Governance Forum, *Statement of the European Corporate Governance Forum on Proportionality* 2 (2007); *see also OECD Principles of Corporate Governance*, *supra* note 5, at 51 (noting that information about beneficial ownership may be necessary to identify related party transactions).

105 *See* Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 440 (2008) (offering a cross-country analysis of private enforcement mechanisms that gov-

tute a useful form of ex ante disclosure.

Controlling shareholders may divert corporate assets not only through tunneling, but also by forcing the company to simultaneously pay out dividends and assume significant debt, to the detriment of long term stakeholders. This, at least, appears to be the concern of the European Commission, which has therefore proposed that private equity funds acquiring a 30% stake in listed companies not only disclose their identity but also provide other information to stakeholders (i.e., the issuer, minority shareholders and employee representatives), such as a policy for preventing and managing conflicts of interests between the fund and the issuer.[106]

Lastly, ownership disclosure can enable shareholders to make informed corporate governance decisions, such as choosing directors or authorizing fundamental transactions.[107] In Europe, both the Transparency Directive and the Shareholders' Rights Directive aim to ensure that shareholders can exercise their rights in an informed manner.[108] Ownership disclosure contributes to this, again, by exposing potential conflicts of interest.

Of course, even if it is clear that there is a conflict of interest, the controlling shareholder will, as a practical matter, determine the outcome of the vote. This limits the extent to which ownership disclosure can improve the quality of the shareholder decisionmaking process in firms with concentrated ownership.[109] To counter this problem, related party transactions are often subject to exclusive approval by the noninterested shareholders. In those cases, ownership disclosure fulfills a special role. As Bernard Black has argued, "insiders have a further incentive to disguise their

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ern related party transactions, and finding that civil law countries tend to have fewer ex ante disclosure requirements than common law countries). *But see* Pierre-Henri Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy*, 4 EUROPEAN COMPANY & FIN. L. REV. 491, 505 (2007) (nuancing the wider conclusions of the study by Djankov et al. by showing that France, Germany and Italy provide a large array of remedies against self-dealing, but confirming that disclosure requirements in these countries are not ex ante).

[106] *Commission Staff Working Document Accompanying the Proposal for a Directive on Alternative Investment Fund Managers*, at 22, 23, SEC (2009) 576 (Apr. 30, 2009); *Proposal for a Directive on Alternative Investment Fund Managers*, COM (2009) 207 final, art. 28 (Apr. 30, 2009). Indeed, there appears to be growing trend to demand more accountability from shareholders as their level of influence increases. The underlying thinking is reflected in the Dutch Corporate Governance Code, which states that "the greater the interest which the shareholder has in a company, the greater is his responsibility to the company, the minority shareholders and other stakeholders." Dutch Corporate Governance Code (2008), at 7.

[107] *See* Kraakman, *supra* note 94, at 96 (referring to this function as the 'educative function' of disclosure).

[108] Transparency Directive, *supra* note 10, § 22 & art. 17 (2); Parliament and Council Directive 2007/36 of 11 July 2007, On the Exercise of Certain Rights of Shareholders in Listed Companies, § 6 & art. 5, 2007 O.J. (L 184) 17 [hereinafter Shareholders' Rights Directive].

[109] 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. L. STUD. 289, 304, 305 (2008).

ownership, so they can pretend to be noninterested [and vote]. Disclosure rules, and rules that treat affiliates of insiders as interested shareholders, are needed to prevent this."[110] This is one of the reasons why he counts ownership disclosure among the "core institutions" that control self-dealing.

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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.[111] 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.[112]

True, the law and finance literature has been subject to criticism.[113] But even scholars who have gone so far as to construe a new "shareholder protection index" have consistently included ownership disclosure as a variable.[114] 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.[115]

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

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[110] Bernard Black, *The Core Institutions that Support Strong Securities Markets*, 55 BUS. LAW. 1565, 1588 (2000).

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

[112] Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 19 (2006).

[113] *See, e.g.*, CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW & CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD 21 (Univ. of Chicago Press 2008); Mathias M. Siems, *What Does Not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology*, 16 INT'L COMPANY & COM. L. REV. 300 (2005); Mark J. Roe, *Legal Origins, Politics and Modern Stock Markets*, 120 HARV. L. REV. 462 (2006).

[114] *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).

[115] *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, 2007).

conflicts of interest on timely basis 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.[116] 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 Armour and Gordon, we can distinguish two types of firms with dispersed ownership.[117] One is characterized by retail ownership and predominantly found in the U.S.; 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.[118] 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 U.S.[119]

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 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 desired. Inevitably, this has ramifications at the European level – the complicated legislative process preceding the Takeover Directive springs to mind.[120] 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.[121] 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

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[116] *See* references, *supra* note 95.

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

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

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

[120] Directive 2004/25/EC of 21 Apr. 2004, On Takeover Bids, 2004 O.J. (L 142) 12 [hereinafter Takeover Directive].

[121] *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.

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 lack of transparency of the ownership structure may result in malfunctioning of the market for corporate control.[122] Hence, the Takeover Directive now requires significant direct and indirect shareholdings to be published in the annual report.[123]

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.[124] A toehold can also offer a strategic advantage vis-‡-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 their bid.

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.[125]

The bidder's gains from stakebuilding can be considered from different perspectives. From an efficiency perspective, they can be considered a reward for the effort of searching for potential synergies.[126] They can 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.[127] 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 incen-

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[122] High Level Group, *supra* note 91, at 98.

[123] Takeover Directive, *supra* note 120, art. 10. This provision has led to amendment of the relevant accounting directives: 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.

[124] Jeremy Bulow, Ming Huang & Paul Klemperer, *Toeholds and Takeovers*, 107 J. POL. ECON. 427, 428 (1999).

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

[126] Daniel Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 13 (1978); Davies, *supra* note 13, at 262.

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

tives to incur search costs, to the detriment of the market for corporate control.[128]

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.[129] However, as argued by Luca Enriques, the 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.[130] Much of his line of reasoning applies equally to the limitation of a bidder's profits from stakebuilding on grounds of fairness and equal treatment.[131]

Adding to the complexity is the fact that disclosure functions as an early warning system to *target management*, enabling it to respond, for example, by mounting defensive measures.[132] Mandatory disclosure thus potentially undermines the market for corporate control.[133] 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.[134] 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 con-

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[128] Fischel, *supra* note 126, 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* http://ssrn.com/abstract=265429.

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

[130] Luca Enriques, *The Mandatory Bid Rule in the Takeover Directive: Harmonization Without Foundation?*, 1 EUROPEAN COMPANY & FIN. L. REV. 440, 448, 452, 456 (2004).

[131] *See also* Fischel, *supra* note 126, 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.

[132] Historically, 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).

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

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

cert.[135] Indeed, one commentator has suggested that Germany's recent decision to lower its initial reporting threshold to 3% was driven by the controversial approach of Deutsche Börse by hedge funds in 2005.[136] In some countries, issuers are provided with additional tools to trace suitors. UK-listed companies, for example, have a statutory right to demand clarification from any person whom they believe to be interested in the company's shares.[137] One expert group has recommended the European Commission consider adopting such a right at the European level.[138] Still, this tool may prove to be 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."[139] A study by the FSA concludes that, by minimizing toeholds and providing information on impending takeovers, ownership disclosure should overall improve the contestability of the market for takeovers.[140] This suggests that ownership disclosure can 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. Ownership disclosure can enable communication between the company and its shareholders, and among shareholders. This can be particularly valuable in firms with dispersed share ownership.

Knowing fellow shareholders enables shareholders to exchange thoughts, to agree among themselves and to effectively assert their rights.[141] 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

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[135] *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 EUROPEAN BUS. ORG. L. REV. 535, 567-75 (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, 45 (2007).

[136] Dorothee Fischer-Appelt, *Implementation of the Transparency Directive – Room for Variations Across the EEA*, 2 CAPITAL MARKETS L. J. 133, 148 (2007).

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

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

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

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

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

the European Commission.[142] But it may not always be easy to identify fellow shareholders.[143] In many jurisdictions, shareholders will rely on ownership disclosure 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.[144] In fact, 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.[145]

There are, of course, other means through which a company can trace the identity of its shareholders.[146] For instance, in the case of registered shares or dematerialized bearer shares, the company may be able to track its shareholders 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.[147] By contrast, an ad hoc disclosure obligation as imposed by the Transparency Directive puts the burden on the beneficial shareholder and thereby ensures timely disclosure of his interests.

In sum, 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 U.S. firms, which shows that 25% of respondents learned of activist investors' ownership though an SEC filing.[148]

C. Extending the Framework to Insider Trading

The previous sections have described the mechanisms through which ownership disclosure by major shareholders can improve market efficiency and corpo-

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142 *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).

143 *See* Siems, *supra* note 141, at 135.

144 *Id*. at 132-47.

145 European Commission, *supra* note 44, at 19, 25.

146 For an overview, see Siems, *supra* note 141, at 132-44.

147 *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 109, at 331. The European Association for Listed Companies (EALIC) has pressed the European legislature to address this issue among other reasons because "investors and issuing companies need to be able to identify key shareholders." Letter from EALIC to the chairman of the Committee on Legal Affairs of the European Parliament (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 MAG., Oct. 2007.

148 REPORT OF THE CONFERENCE BOARD RESEARCH WORKING GROUP ON HEDGE FUND ACTIVISM 22 (2008), *available at* http://ssrn.com/abstract=1107027.

rate 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 insiders (particularly managers) own shares constitutes fundamental information. A survey among institutional investors shows that they consider inside ownership key in making investment decisions.[149] Why? Presumably because the lower the level of insider ownership, the higher the potential agency costs due to misalignment between the incentives of outside investors and management.[150] On the other hand, significant inside ownership causes entrenchment, which could increase agency costs. There is some empirical research suggesting that firm value does indeed vary according to the level of inside ownership.[151] Disclosure of inside ownership, by signaling the potential for increased or reduced agency costs, enables investors to assess the implications of inside ownership for the value of the share. By the same token, disclosure of transactions changing the level of inside ownership allows investors to re-assess incentive and entrenchment effects and to assess the implications for the value of the share.

Disclosure of transactions by insiders also contributes to market efficiency through a different mechanism. As with disclosure of transactions by major shareholders, disclosure of transactions by insiders may convey *underlying* fundamental information driving the transactions.[152] 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.[153] This 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.[154] It may come as no surprise, then, that markets tend to respond

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[149] McCahery & Sautner, *supra* note 88, at 50.

[150] *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.

[151] *See* Randall Morck et al., *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. FIN. 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.

[152] This notion is reflected in the recitals of the Market Abuse Directive, which contains the European rules on insider trading and states that the publication of transactions by insiders can be a 'highly valuable source of information to investors.' Market Abuse Directive, *supra* note 100, at 22.

[153] Of course, insiders' trades can also be conducted for other reasons, including for diversification and liquidity reasons.

[154] *See, e.g.*, H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16

to disclosure of insider trading.[155] 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.[156]

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.[157]

Finally, disclosure of transactions by insiders can improve corporate governance, by facilitating enforcement of the prohibition to trade on non-public information. This mechanism is acknowledged in the recitals of the Market Abuse Directive[158] and a related directive, which states that the information is not only valuable to market participants, but also constitutes a means for authorities to supervise markets.[159]

J. FIN. ECON. 189 (1986); Josef Lakonishok & Inmoo Lee, *Are Insider Trades Informative?*, 14 REV. FIN. STUD. 79, 93 (2001).

[155] *See, e.g.*, Jana P. Fidrmuc et al., *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). *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). *But see* Lakonishok & Lee, *supra* note 154, at 82 (do not observe any major stock price changes when studying US stock market response to insider trading);

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. FIN. STUD. 637 (1995).

[156] Fidrmuc et al., *supra* note 155, at 2933; McConnell et al., *supra* note 33, at 104.

[157] *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).

[158] Market Abuse Directive, *supra* note 100, at 26.

[159] 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, at 7, 2004 O.J. (L 162) 70.

II. Hidden Ownership

The over-the-counter equity derivatives market has grown exponentially over the last decade, with an estimated notional amount as high as $10.2 trillion at the end of June 2008 - more than half of which was accounted for by derivatives of European shares.[160] Equity derivatives are regularly used by hedge funds to leverage their exposure.[161] Yet, 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 shares.[162] 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:

First, 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 to influence control, resulting in a lack of transparency.

Second, cash settled derivative contracts, despite their terms, may be physically settled. Once a 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 U.S. railroad company. TCI had amassed a significant stake in CSX partly through total return swaps (TRS),

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[160] BANK FOR INTERNATIONAL SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE FIRST HALF OF 2008, 3 (2008). Not surprisingly, given the financial crisis, the number had dropped to $6.5 billion by end 2008. BANK FOR INTERNATIONAL SETTLEMENTS, SEMIANNUAL OTC DERIVATIVES STATISTICS AT END-MARCH 2009.

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

[162] *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).

the U.S. equivalent of Cfd, which it had not immediately disclosed.[163] CSX felt this had enabled TCI to ambush CSX in the run-up to a proxy contest, and sued TCI for violation of U.S. securities laws. The case focused on whether TCI qualified as beneficial owner of the reference shares; if so, it would have been subject to a disclosure obligation.[164] 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.[165]

As to *investment power*, the court observed that TCI had significantly influenced its counterparties to purchase or sell CSX shares.[166] This conclusion was based on the facts that (1) it was inevitable, due to the "very nature" of the TRS, that TCI's counterparties would hedge the TRS by purchasing CSX shares, (2) this is what TCI contemplated, and (3) the counterparties did in fact hedge their positions.[167] This also explains why TCI limited the size of its TRS with individual counterparties: to avoid triggering a disclosure obligation on their part.[168] 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."[169]

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.[170] 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 Bank. In doing so, TCI was motivated by the belief that it could influence how Deutsche Bank voted its CSX shares.[171] Remarkably, Deutsche Bank next

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[163] *Investopedia.com* offers the following explanation of TRS: "[i]n a total return swap, the party receiving the total return will receive any income generated by the asset as well as benefit if the price of the asset appreciates over the life of the swap. In return, the total return receiver must pay the owner of the asset the set rate over the life of the swap. If the price of the assets falls over the swap's life, the total return receiver will be required to pay the asset owner the amount by which the asset has fallen in price." http://www.investopedia.com/terms/t/totalreturnswap.asp.

[164] Rule 13d-3(a) of the Exchange Act, 17 C.F.R. § 240.13d-3(a) (2010) (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).

[165] CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) L.L.P., 562 F. Supp. 2d 511, 541 (S.D.N.Y. June 11, 2008). For a discussion, see Daniel Bertaccini, *To Disclose or Not to Disclose? CSX Corp., Total Return Swaps, and Their Implications for Schedule 13d Filing Purposes*, 31 CARDOZO L. REV. 267 (forthcoming 2009).

[166] Bertaccini, *supra* note 165 at 61.

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

[168] *Id.* at 53.

[169] *Id.*

[170] *Id.* at 61.

[171] *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.

recalled the shares, which it had lent out, in order to be able to vote them at the shareholder 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."[172]

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.[173] 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 agreements that would have triggered disclosure obligations.[174]

These are not unique cases. 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.[175] These have changed the political economy and spurred lawmakers into action. Both the UK Takeover Code and the Irish Takeover Code now require economic interests to be disclosed during offer periods,[176] and the scope of the general UK disclosure regime has recently been expanded along the same lines.[177] Similar regulatory developments have occurred in France, Switzerland, Australia and Hong Kong.[178] In other jurisdictions, such as Canada and the Netherlands, regulators are contemplating amending the rules.[179] Courts have also addressed the issue, for

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172 *Id.* at 58.

173 Dirk A. Zetzsche, *Continental AG vs. Schaeffler, Hidden Ownership and European Law - Matter of Law or Enforcement?*, 10 EUROPEAN BUS. ORG. L. REV. 115, 119 (2009).

174 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 173, at 126.

175 Hu & Black, *supra* note 157.

176 UK Takeover Code, art. 8(3); Irish Takeover Rules, art. 8(3).

177 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).

178 General Regulation of the Autorité des Marchés Financiers, section 223-14 (in force as of November 1, 2009); Ordinance of the Swiss Federal Banking Commission on Stock Exchanges and Securities Trading, section 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).

179 CANADIAN SECURITIES REGULATORS, PROPOSED NATIONAL INSTRUMENT 55-104

example in New Zealand and Italy.[180] Nonetheless, the issue has only marginally received attention at the European level thus far.

A. Existing Disclosure Requirements

Now, let us consider briefly the extent to which hidden ownership is captured by existing disclosure requirements. To ensure disclosure by the beneficial owner, the Transparency Directive extends 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."[181] Consequently, disclosure obligations also apply when, for example, voting rights are held by controlled entities.[182] Various criteria are used to try to capture the beneficial owner, such as "power to exercise dominant influence or control," "discretion," "instruction" and "independently."[183] 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.[184] 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]."[185] This suggests a more formal approach.

Indeed, in the case of Cfd that do not grant a right of acquisition of the un-

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INSIDER REPORTING REQUIREMENTS AND EXEMPTIONS, COMPANION POLICY 55-104CP INSIDER REPORTING REQUIREMENTS AND EXEMPTIONS AND RELATED CONSEQUENTIAL AMENDMENTS, 9 (2008); DUTCH MINISTRY OF FINANCE, VOORSTEL WIJZIGING WFT UITBREIDING MELDINGSPLICHT SUBSTANTIËLE ZEGGENSCHAP- EN KAPITAALBELANGEN MET ECONOMISCHE LONG POSITIES (2009).

[180] 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 J. INT'L BANKING & FIN. LAW 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).

[181] 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).

[182] *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.'

[183] 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.

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

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

derlying shares at settlement, there is no obligation to disclose pursuant to article 13 of the Directive.[186] 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," and such right must derive from an agreement that is binding under applicable law.[187] This 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. Article 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.[188]

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.[189] 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.[190] On the basis of this interpretation, Dirk Zetzsche has developed a compelling argument that equity swaps such as those employed by Schaeffler should trigger a disclosure obligation under this article.[191]

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.[192] The FSA, in conducting an extensive analysis of Cfd in relation to existing disclosure obligations, did not refer to the arti-

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186 *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 194, at 2 (announcing that it will address the possibility of application of the notifications regime to derivative products).

187 Commission Directive 2007/14/EC, *supra* note 183, art 11 (1).

188 CESR, *supra* note 186, at 29.

189 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.

190 *See* Zetzsche, *supra* note 173, at 133.

191 *Id*.

192 CESR, *supra* note 186, at 33.

cle or to its UK law equivalent.[193] Nor does the fact that market participants, commentators and even the European Parliament have called upon the European Commission to increase transparency suggest that current rules provide adequate disclosure.[194] 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 as a framework for analysis of hidden ownership, and shows that hidden ownership severely undermines these mechanisms. Thus, it becomes clear why hidden ownership is so problematic.

1. Adverse Effects on Market Efficiency

Ownership disclosure can inform share prices, and thereby improve market efficiency, by creating transparency of the voting structure and of capital movements. As we will see below, hidden ownership reduces transparency of both the voting structure and capital movements.

a. Reduced Transparency of the Voting Structure

By creating transparency of the voting structure, Part I demonstrated ownership disclosure enables investors to anticipate agency costs and to assess the implica-

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

[194] *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'* 14 (Sept. 2007) (suggesting that the Commission address the issues raised by derivatives); CESR, FEEDBACK STATEMENT, CESR/08-66, 2 (2008) (suggesting 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 . . . 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 at 3 (Sept. 14, 2007) (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*, FIN. TIMES, June 29, 2008.

tions for the value of a firm's share. Hidden ownership reduces transparency of the voting structure in several ways. 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."[195]

Hidden ownership also reduces transparency 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.[196] This affects not only market efficiency, but also the operation of rules that rely on efficient markets. The Takeover Directive requires that a mandatory bid be made against an "equitable price," defined as the highest price paid (on or off the market) for the target shares by the acquirer during a certain period, e.g. 12 months, prior to the bid.[197] Similarly, the laws of some Member States require that if no target securities have been acquired during that period, the equitable price be defined as the average market price during such period.[198] In each case, one could argue, it is implicitly assumed that the share price reflects the increased probability of a control contest. This assumption is no longer valid if the market is unable to anticipate a control contest because the acquirer silently built his stake through derivatives. Thus, derivatives enable acquirers to effectively reduce the price to be paid in the mandatory bid.[199]

b. Reduced Transparency of Capital Movements

Ownership disclosure also informs share prices by creating transparency of trading interest, of the size of the free float and of economic interests of shareholders.

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[195] Bertaccini, *supra* note 165, at 11.

[196] 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 135, at 11.

[197] Takeover Directive, *supra* note 120, art. 5(4).

[198] *See, e.g.*, Art. 25(2) of the Dutch Decree on Public Offers.

[199] Dirk A. Zetzsche, *Challenging Wolf Packs: Thoughts on Efficient Enforcement of Shareholder Transparency Rules*, at 10, 11 (2009), *available at* http://ssrn.com/paper=1428899. Some Member States, such as the UK, partially solve this problem by not only taking into account, when computing the equitable price, the highest price paid by the acquirer for target shares, but also the highest price paid for derivatives. UK Takeover Code, rule 9.5, note on rule 9.5, ¶ (2)(a)(v).

Again, hidden ownership reduces this transparency. First, 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 bank acting as counterparty does not need to disclose its purchase of reference shares because the fund transacted with a number of banks and kept the volume of each transaction below the initial threshold for disclosure, 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.[200]

Second, hidden ownership may distort the market's perception of the size of the free float. In the example of a long party transacting with a number of banks, none of which have to disclose their purchase of reference shares, the free float may be significantly reduced because the reference 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 in late 2008 disclosed that it had increased its economic stake in Volkswagen from 35% to 74.1% through cash settled options.[201] 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 reference 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 supplied by hedge funds that 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."[202] A leading corporate governance expert observed that the incident "should get the politicians and supervisory authorities to think again about allowing this untransparent situation."[203]

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[200] 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. THE PANEL ON TAKEOVERS AND MERGERS, DEALINGS IN DERIVATIVES AND OPTIONS, CONSULTATION PAPER PCP 2005/1, 11 (2005). *But see* FSA, *supra* note 177, at 9 (responding to calls for greater transparency of Cfd irrespective of their control implications by stating that it does not have compelling evidence of market failure in respect of inefficient price formation caused by a lack of transparency).

[201] Milne, *supra* note 1.

[202] *Id*.

[203] *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

Finally, the long party's true interest remains undisclosed. Because its economic ownership *exceeds* its formal voting rights, though, 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 decisionmaking, it may therefore be risk-averse to a different degree than ordinary shareholders. This, it would seem, is less of a concern than some of the other issues associated with hidden ownership.

2. Adverse Effects on Corporate Governance

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 non-public 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.[204] Interestingly, the International Organization of Securities Commissions (IOSCO) has acknowledged that "the reporting of short positions might not provide a full picture if the data excludes derivatives."[205]

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.[206] 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, the market for corporate control may be adversely affected overall.

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single stock. *See* FSA, *supra* note 79, annex 3, at 7; *see also* IOSCO, *supra* note 75, at 15 (noting that "[i]nformation that sales are short creates an awareness that, at some future point, many of those sales will need to be reversed by new purchases," but also that disclosure of short positions "would leave some short sellers vulnerable to tactical behavior that may trap them in bear squeezes").

[204] *See, e.g.*, SEC Release No. 34-58785, at 8; FSA, *supra* note 81, at 10; *see also* IOSCO, *supra* note 76, at 13 (enumerating a number of enforcement related issues that regulators should take into account in establishing a reporting regime); *Working Document of the Commission Services (DG Internal Market): Consultation Paper on Hedge Funds*, at 6 (2008) (noting that "enhanced transparency of short selling practices should be envisaged as a minimum" to detect abusive trading strategies). *But see* FSA, *supra* note 80, at 112 (noting that the FSA's legal powers to require disclosure of short selling positions may need to rest on a responsibility to maintain orderly markets and financial stability instead of being based on the market abuse regime).

[205] IOSCO, *supra* note 76, at 14.

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

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 minority 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 each case, 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 U.S. issuers had amended their bylaws to require full disclosure of derivative positions by shareholders submitting a proposal or nominating directors for election at shareholder meetings.[207]

A related concern is 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.[208] The FSA has dismissed this concern on the ground that it sees no evidence of a market failure here.[209] 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.

Finally, while this section has focused on how hidden ownership affects the efficiency of ownership disclosure rules, it should be emphasized that hidden ownership can also affect the efficiency of other rules, such as the mandatory bid rule. Pursuant to the Takeover Directive, the mandatory bid obligation is triggered upon acquisition of control of the issuer, as proxied by a percentage of voting rights (e.g.,

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[207] 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.

[208] Letter from EuropeanIssuers to Charlie McCreevy, Eur. Comm'r (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.

[209] FSA, *supra* note 177, at 9.

30%) specified by the Member State. Thus, the same potential problem arises: if the scope of the Member State's relevant provision does not include cash settled equity derivatives, acquirers may be able to circumvent the mandatory bid rule by building their stake in part through such derivatives. Accordingly, in the UK, not only shares and physically settled equity derivatives count toward the mandatory bid trigger, but so do cash settled equity derivatives.[210] This is not the case in every Member State, however. In Italy, for example, the use of cash settled equity derivatives apparently enabled the Agnelli family to retain control of carmaker FIAT while avoiding a mandatory bid obligation.[211] This reinforces the need for a systematic analysis of the impact of equity derivatives on rules pursuant to which the holding of a certain amount of shares triggers certain obligations.

III. Empty Voting

Hu and Black have characterized as "empty voters" persons whose voting rights substantially exceed their net economic ownership.[212] 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 was 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 in 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.[213] Thus, it could be 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 Mylan and its (other) 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 U.S. as

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[210] UK Takeover Code, Rule 9.

[211] For a discussion of this case, see Tom Kirchmaier et al., *Financial Tunnelling and the Mandatory Bid Rule* 12-14 (2009), *available at* http://ssrn.com/paper=613945; *see also* references *supra* note 180.

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

[213] Perry also deferred disclosure of its stake in Mylan pursuant to Rule 13d-3 of the Exchange Act, 17 C.F.R. § 240.13d-3. However, in 2009, the SEC found that Perry was not entitled to defer filing pursuant to this rule because its acquisition of Mylan securities was not "in the ordinary course" of its business, and Perry agreed to pay a penalty of $150,000. SEC, Administrative Proceeding File No. 3-13561, *In the matter of Perry Corp*.

well as in 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 decisionmaking process in shareholder meetings of listed companies, which explains why the issue has drawn attention from market participants,[214] regulators (including the SEC)[215] and academics.[216] In spite of this, the issue has, again, only received marginal attention at the European level.[217]

To be sure, just as it can be legitimately questioned whether mandating one share-one vote would be socially beneficial, it can be questioned whether an absolute ban on empty voting would be socially beneficial. A study by Christoffersen et al., for example, suggests that vote trading may serve the socially beneficial role of incorporating more information in corporate votes.[218] Similarly, 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.[219]

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[214] European Commission, *supra* note 194, at 3, 14 (showing that there is general support among respondents for measures enhancing transparency of stock lending and that a majority of respondents believe that the issue needs to be addressed at EU level); CESR, *supra* note 194, at 2 (respondents advocate application of the notifications regime to stock lending and derivatives); European Corporate Governance Forum, *supra* note 104, at 2 (suggesting that shareholders holding in excess of a certain percentage of outstanding share capital, 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 by EuropeanIssuers (Dec. 12, 2008) (advocating complete transparency of stock lending towards all concerned parties, including the issuer), *available at* http://www.europeanissuers.eu.

[215] *See, e.g.*, John White, SEC staff, Keynote Address at ABA Section of Business Law Fall Meeting: *Don't Throw Out Baby With Bathwater* (Nov. 21, 2008). In Delaware, where many U.S. Fortune 500 companies are incorporated, Section 213 of the Delaware General Corporation Law has recently been amended to partially respond to empty voting, by allowing corporations to set a voting record date separate from (i.e., later than) the record date for notice of the shareholder meeting, which can be set as much 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. Shareholders' Rights Directive, *supra* note 108, art. 8(3).

[216] *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).

[217] 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 194.

[218] Susan E. K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2927 (2007).

[219] Alon Brav & Richmond D. Mathews, *Empty Voting and the Efficiency of Corporate Governance* (March 2009). AFA 2009 San Francisco Meetings Paper, *available at*

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 the potential of empty voting becomes transparent under existing disclosure requirements.

A. Existing Disclosure Requirements

European Commissioner McCreevy, announcing he would neither pursue one share-one vote nor expand disclosure requirements, has stated that the Transparency Directive already contains ample provisions on transparency.[220] 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.[221] The studies also point at the lack of transparency with regard to the decoupling of voting rights from economic ownership through securities lending and derivatives.[222]

Indeed, the Directive offers hardly any transparency with respect to cash flow rights and even less with respect to empty voting. Acquiring a substantial number of shares *per se* does not trigger a disclosure obligation, contrary to the U.S.[223] The Directive also falls short of requiring disclosure of the number of shares held on the

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http://ssrn.com/abstract=1108632. For a broader discussion of the potential for empty voting to produce inefficient outcomes, see Hu & Black, *supra* note 82, at 668-79.

[220] McCreevy, *supra* note 52.

[221] 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 115, 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").

[222] 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 115, 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).

[223] Rule 13d-3 of the Exchange Act, 17 C.F.R. § 240.13d-3 (2010).

notification form, let alone arrangements affecting economic exposure.[224] The fact that cash flow rights did not need to be reported under the precursor of the Directive was identified more than a decade ago as a major reason why it was difficult to measure the separation between ownership and control in European firms.[225] Unfortunately, the Directive has not changed this. U.S rules again go much further, especially for shareholders whose stake exceeds 10% by requiring them to disclose not only the number of shares and options held but also other arrangements affecting their economic exposure.[226]

Despite the limited scope of the Directive's disclosure rules, the rules at the level of individual Member States may be tighter, given that the Directive allows this.[227] While Member States have indeed imposed stricter disclosure requirements in many respects, they have not done so with respect to economic interests.[228] Only in a few Member States can a disclosure obligation be triggered both as a result of acquiring voting rights and as a result of acquiring shares.[229] Moreover, only in about half of the Member States 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.[230]

Member States have also taken divergent approaches with respect to securities lending. In some Member States, 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.[231] In the latter case, the market remains unaware of both the fact that the borrower has no economic interest and the fact 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. Basically, the answer is yes. Under

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[224] 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 186, 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").

[225] Becht, *supra* note 8, at 87.

[226] 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).

[227] 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").

[228] CESR, SUMMARY OF RESPONSES TO QUESTIONNAIRE ON TRANSPOSITION OF THE TRANSPARENCY DIRECTIVE, CESR/08-514B (2008); *see also* European Commission, *supra* note 135.

[229] 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).

[230] CESR, *supra* note 228, at 4, 5.

[231] *Id.* at 3.

this directive, a disclosure obligation is triggered in the case of transactions in the share or "derivatives or other financial instruments linked to them."[232] Moreover, the notification should include a description of such financial instruments.[233] These rules thus have a broader scope than the rules under the Transparency Directive – pretty much like U.S. rules on insider trading do.[234] 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 as a framework for analysis the taxonomy of mechanisms through which ownership disclosure improves market efficiency and corporate governance, it becomes clear that empty voting, too, severely undermines these mechanisms.[235]

1. Adverse Effects on Market Efficiency

Recall that one of the mechanisms through which ownership disclosure informs share prices is by creating transparency of economic interests of shareholders. By exposing that the incentives of the shareholder whose voting rights exceed her economic exposure are distorted, transparency allows investors to assess the implications for the value of the share.[236] In case of a potential for empty voting, however, the market relies even more heavily on ownership disclosure for information than in case of conventional deviations from one share-one vote. Information on the latter is provided by an array of sources, including company statutes and initial and ongoing issuer disclosure requirements.[237] This explains, for example, 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.[238] 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

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[232] Market Abuse Directive, *supra* note 100, art. 6(4).
[233] Commission Directive 2004/72/EC, *supra* note 159, art. 6(3)(d).
[234] Exchange Act Rule 16a-1(a), 16a-2, 17 C.F.R. § 240.16a-1(a), 16a-2 (2005).
[235] 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. For an emerging body of literature addressing this broader question, see references *supra* note 216.
[236] *See supra* notes 44–56 and accompanying text.
[237] For an overview, see ECGI et al., *supra* note 48, at 17; European Commission, *supra* note 115, at 70.
[238] Burkart & Lee, *supra* note 52, at 34, 35.

the 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.

2. Adverse Effects on Corporate Governance

Finally, in terms of corporate governance, transparency 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 interest is trying to determine the outcome of 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 in empty voting in the first place.[239] 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.[240]

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 Article.

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

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

[240] *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").

voting structure is the Directive's "exclusive" purpose.[241] But this Article 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.[242]

Moreover, the analysis suggests that the Transparency Directive in its present form does not effectively prevent hidden ownership, and that hidden ownership 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.[243] Yet, while most of this Article 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.[244]

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[241] 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]."

[242] 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 structure of pyramids. High Level Group, *supra* note 91, at 96, 98. The evaluation should therefore first and foremost be concerned with determining whether the Directive has sufficiently improved this situation.

[243] For detailed proposals on how to expand the UK disclosure rules, see FSA, *supra* note 177. With respect to the U.S. 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).

[244] The cost-benefit analysis conducted by the FSA prior to the expansion of the scope of the UK ownership disclosure regime focuses heavily on incremental compliance costs (including upfront costs and ongoing costs), which is understandable given that these costs can at least to some extent be quantified. Yet the FSA also observes that "[o]ne of the difficulties of producing a robust [cost-benefit analysis] in this area is the possible variations of the indirect costs. These costs, which can manifest themselves in a large variety of ways, are often difficult to predict and can be impossible to quantify [nevertheless, these costs can be more significant than the direct costs]." The FSA identifies the following potential indirect costs, some of which are discusses in more detail below: (i) negative impacts on the activity of hedge funds and other investors who seek to profit from undertaking research and exploiting arbitrage opportunities; (ii) negative impacts on the CfD volumes written by banks; (iii) reduced demand for the underlying shares, to the detriment of issuers; (iv) increased cost for market participants due to monitoring a higher number of disclosures for meaningful information, and risk of reduced liquidity due to excessive information. FSA, *supra* note 65, annex 1 at 6-10. *See also* Isaac Alfon & Peter Andrews, *Cost-Benefit Analysis in Financial Regulation: How To Do It and How It Adds Value*, FSA Occasional Paper Series nr. 3, at 10, 11 (noting that "[t]he main conceptual problem is that satisfactory [cost-benefit analysis] is difficult to achieve within any given sector, given that optimum conditions do not obtain in the rest of the economy. Under these 'second best' conditions, it is not certain that an improvement in one sector would make the country as a whole better off, for example because market valuations of resources may be

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.[245] Given that preliminary findings suggest hedge fund activism benefits existing shareholders,[246] regulators should caution not to unduly limit hedge funds' ability to engage in activism.[247] 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.[248]

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. In the U.S., some issuers have changed their shareholder rights plans to explicitly include derivatives when calculating the level of beneficial ownership that triggers the poison pill.[249] Skeptics of the pill may be concerned about the adverse affects this strategy could have on the market for corporate control.[250] 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.[251]

Indeed, the fact that issuers are among the loudest proponents of increased transparency should caution policymakers to carefully examine their motivations.[252] This is of particular concern given that the current financial crisis may have affected

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unreliable," and also noting that the main practical problem is lack of data, partly as a result of the difficulties that arise in the identification of compliance costs); Christian Leuz & Peter D. Wysocki, *Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research* (2008) (reviewing the theoretical and empirical literature on the economic consequences of financial reporting and disclosure regulation), *available at* http://ssrn.com/abstract=1105398.

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

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

[247] 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.

[248] Letter from the Alternative Investment Management Association (AIMA) to the FSA (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").

[249] Mara Lemos-Stein, *Poison Pills Target Derivatives*, WALL ST. J., June 18, 2008; Charles M. Nathan, *Second Generation Advance Notice Bylaws and Poison Pills* (2009), *available at* http://blogs.law.harvard.edu/corpgov/2009/04/22/second-generation-advance-notice-bylaws-and-poison-pills/.

[250] *See also* Hu & Black, *supra* note 2, at 841 (noting that reducing bidder resistance could enhance the market for corporate control); *supra* notes 132-134 and accompanying text.

[251] *See supra* note 135 and accompanying text.

[252] *See supra* note 132 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).

the political economy so as to make policymakers even more responsive to issuers' concerns over hedge fund activity.[253] A case in point is the restriction of short selling, the efficacy of which remains controversial.[254]

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.[255] 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 circumstances.[256] 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.[257]

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In assessing the costs and benefits of increased disclosure, policymakers should also be mindful of the limitations of the law. Even if disclosure rules are updated, acquirers, with the help of financial and legal advisers, can be expected to devise new and sophisticated ways to circumvent those rules. Indeed, 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."[258]

This observation fits within a broader theory that law is inherently incom-

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[253] *Cf.* McCahery & Vermeulen, *supra* note 135, 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).

[254] For a survey of the literature on this point, see FSA, *supra* note 79, Annex I.

[255] ESME, *supra* note 3, at 7. Notice that the risk of overflow appears to be smaller if the targeted audience consists primarily of financial professionals, who can be expected to identify material information more easily.

[256] Brav & Mathews, *supra* note 219, at 29.

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

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

plete due to the fact that lawmakers are unable to foresee all future contingencies.[259] 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 calls 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.[260]

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.[261] Focus 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 in part to the laxity in enforcement.[262] A related study found substantial variations across Eastern European countries in what companies disclose regarding their corporate governance arrangements, and concluded that while accession to the European Union has been successful in transforming the laws on the books, implementation at firm level is still lagging.[263]

Conclusion

This Article has explored the fundamental question of why we have owner-

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259 Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931 (2002–03).

260 FSA (2009), *supra* note 177, at 6, 7 and DTR 5.3.1 R 1 (b) (ii) (in force as of June 1, 2009).

261 John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 50 (Oxford University Press 2009); *see also* Siems, *supra* note 141, 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).

262 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 267, 286, 291 (P.K. Cornelius & B. Kogut eds., 2003); *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).

263 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 et al., *Firm-Level Transparency in the Former East Bloc: Empirical Evidence from the Baltic Region*, manuscript at 15, *available at* http://ssrn.com/abstract=1098193 (finding that in 2004, Baltic firms disclosed significantly less ownership information than Nordic firms).

ship disclosure rules. Using the European ownership disclosure regime as an example, the Article has first identified two main objectives of ownership disclosure rules: improving market efficiency and corporate governance. Next, it has analyzed how ownership disclosure performs these tasks.

The analysis has shown that ownership disclosure can improve market efficiency through various mechanisms. By creating transparency of the voting structure and of changes in the voting structure, ownership disclosure enables investors to anticipate agency costs and to assess the implications for the value of a firm's share. This way, ownership disclosure informs share prices. Other ways through which ownership disclosure informs share prices is by creating transparency of economic interests of shareholders, of trading interest and of the size of the free float.

The analysis has also shown that ownership disclosure can improve corporate governance through various mechanisms. First, ownership disclosure enables enforcement. In firms with concentrated ownership, it does so by facilitating monitoring of the controlling shareholder, thus preventing extraction of private benefits. In firms with dispersed ownership, it does so by facilitating the market for corporate control, the mechanism through which management is disciplined by takeovers and the threat thereof. Second, ownership disclosure facilitates communication among shareholders and between companies and their shareholders.

The Article 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?[264] This Article 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 Article, but merit careful consideration. First, while the Article has identified benefits as well as costs of disclosure, it does not offer an exhaustive cost-benefit analysis.[265] Indeed, by complicating the taxonomy the Article may have presented policymakers with more questions than answers. But at least this should enable an evaluation of the disclosure regime that

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

[265] Admittedly, to accurately perform a cost benefit analysis is a challenge. As Hu & Black note, because it is unclear, either theoretically or empirically, which disclosure rules are optimal, the efficiency of disclosure avoidance is also unclear. Hu & Black, *supra* note 82, at 671.

takes into account all relevant aspects.

Second, the Article has largely assumed that the voting structure determines who controls the company. But this assumption 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 significant weight as governments have responded to the recent financial crisis by injecting huge amounts of capital in troubled financial institutions.

In late 2008, for example, the Dutch State injected EUR 10 billion in ING, one of Europe's largest financial institutions.[266] 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 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 Article 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 the European level or whether this should be left to individual European countries. The fact that the regime provides for so-called 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 that fostering regulatory competition might be a fruitful approach. Indeed, its rapid response may be seen as an example of what Simon 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.[267]

While it goes beyond the scope of this Article to address this question, two

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

[267] Simon Deakin, *Two Types of Regulatory Competition: Competitive Federalism Versus Reflexive Harmonisation. A Law and Economics Perspective on Centros*, 2 CAMBRIDGE YEARBOOK OF EUROPEAN LEGAL STUD. 231, 260 (1999); *see also* John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation*, 95 GEO. L. J. 1727, 1750, 1751 (2007) (using the UK Takeover Panel's swift response to problems caused by equity derivatives to illustrate the Panel's flexibility and proactive regulatory approach). 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 135; Mathias M. Siems, *The Foundations of Securities Law*, 20 EUR. BUS. L. REV. 141 (2009).

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 Article has shown the floor is currently set too low, which may deter cross-border investment.[268] 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.[269] This raises concerns the Commission should duly take into account when determining its future policy on ownership disclosure.

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[268] *See* Christian Leuz et al., *Do Foreigners Invest Less in Poorly Governed Firms?*, 22 REV. FIN. STUD. 3245 (2009).

[269] *See* ESME, *supra* note 3, at 5; European Commission *supra* note 194, at 14; European Commission, *supra* note 135, at 4, 13.