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CORPORATE GOVERNANCE

Derivatives and hidden ownership: not just a German problem

■ Derivatives: a potential threat to corporate governance

The recent attempt by Porsche to gain control of Volkswagen using cash-settled derivatives has highlighted the increasing ability of outside investors to decouple their economic interests from their legal or voting interests. In our view, this raises serious corporate governance issues for investors and companies across Europe.

■ Hidden ownership = derivatives + voting rights

Cash-settled derivatives are a legitimate and useful tool. However, their use by corporates is a clear example of investors' increasing ability to undermine one of the core principles of corporate governance, i.e. "one share, one vote".

■ Governance impact of hidden ownership can be severe

Hidden ownership implies less efficient pricing in capital markets due to lack of information on corporates' control structures, lack of transparency on large holdings and transactions, possible conflicts of interest and creeping control. Other issues are the avoidance of mandatory bids at an equitable price on a clearly defined timetable, lack of takeover premium and no real exit for minority shareholders.

■ Legal risks may offer more protection than poison pills

Corporates are likely to extend poison pills to include rules on economic ownership in order to capture derivatives and prevent creeping control. However, we believe the best protection against hidden ownership is the inherent legal and reputational risk. Investment service providers and banks are likely to restrict their use of cash-settled derivatives to avoid being suspected of acting in concert or even fraudulently. Beyond transparency, complexity is also a potential liability issue for providers of such products.

■ Solution likely to come from new European regulation

Although cash-settled equity derivatives are not considered to be a financial instrument under the European Transparency Directive, we think a potential amendment to include their notification could be implemented by 2012. Current momentum for ensuring better corporate governance controls tells us that any equity derivative that potentially alters the underlying shareholder structure is a risk.

■ From "hidden" to "silent" ownership

The increasing use of synthetic equity derivative structures by investors (not corporates) combined with a fast growing share of passive index management is another governance issue. As such products are highly concentrated on the major equity indices, this leads to significant "silent" ownership of the corporate constituents of these indices and the abandonment of governance control to their management. Engagement by active shareholders thus become less efficient (e.g. reaching a voting quorum).

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I – Derivatives and corporate governance

The failed pursuit of VW last year involving the use of cash-settled derivative options (a synthetic instrument) exposed a fundamental weakness in capital markets and has significant implications for corporate governance and market transparency.

■ Germany's problem is also Europe's

Cash-settled derivative options do not usually require the delivery of the underlying security, as the corresponding cash value of the underlying derivative is netted against the strike price with the difference paid to the owner of the option. This is because equity derivatives that are settled in cash are used for economic and financial interests and as such do not provide direct access to voting rights in a company's capital.¹ However, options defined as cash-settled may still be physically settled on exercise if the parties so agree, as was the case with Porsche.

While Porsche may have technically complied with German financial law, it can be argued that its actions contributed to a significant lack of market transparency and efficiency by obscuring Volkswagen's control structure.

The European Transparency Directive (TD) was designed to tackle this problem by ensuring a framework for "the disclosure of accurate comprehensive and timely information about security issues in order to build sustained investor confidence and allow for informed assessment of their business performance and needs."

As such, the controversial use of cash-settled derivative options has been viewed as a German problem particularly as the most recent examples of cash-settled options being used to build up hidden stakes have been found in the German market (Porsche and more recently SGL Carbon). However, this does not mean that this issue cannot be replicated in other European markets. The transparency directive requirements relating to the aggregation and public notification of shares and/or financial instruments that provide entitlements to voting rights do not apply to cash-settled derivative options as they are not considered to be a financial instrument.

What is now clear is that the use of cash-settled options has made it much easier for the economic interest of shares in companies to be split from their legal interest. This has significant corporate governance implications, particularly where there is a disproportionate correlation between the legal interest (control) and the subsequent economic interest.

Economic interest vs legal interest

Frank Easterbrook and Daniel Fischel have argued that "*It was not possible to separate the voting right from the equity interest... and someone who wants to buy a vote must buy the stock too.*"²

This notion is one of the foundations of good corporate governance along with the principle of "one share one vote", whereby voting power has a direct and proportional relationship to capital invested.

However, it is not uncommon for situations to occur where disproportionate relationships exist between voting power and capital. In fact, this is not a new issue and examples can be found in many European markets where multiple share classes are used to enfranchise one set of shareholders (in terms of voting power and control) at the expense of other shareholders, irrespective of the actual share capital owned.

Porsche followed the letter of the law...

... but its actions may have hampered market transparency

Foundation of good corporate governance

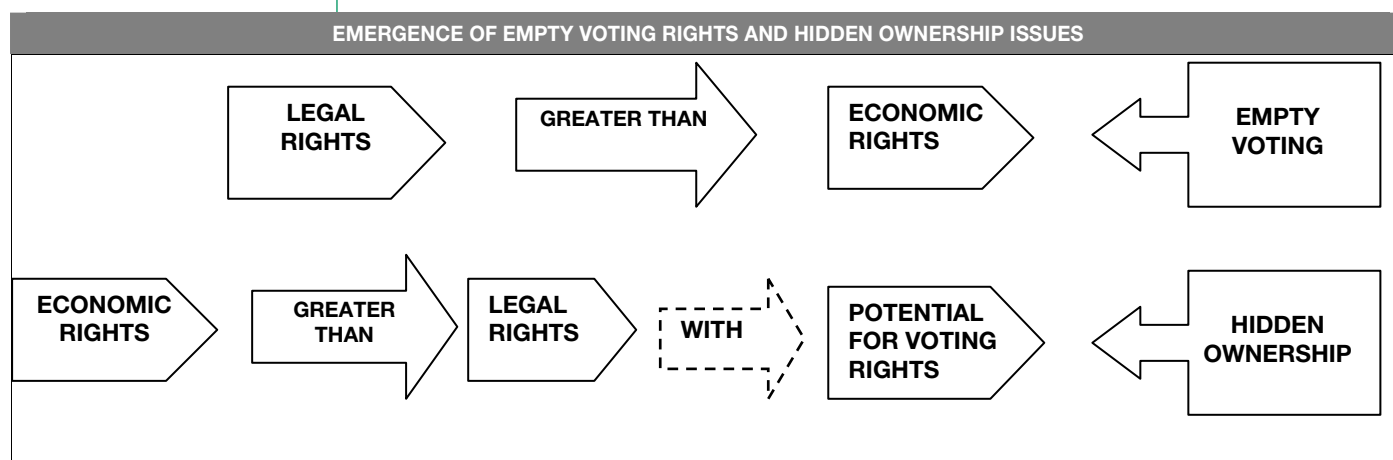
¹ Cash-settled derivatives have become a market standard for institutional and retail investors, because most investors are interested only in the price performance of the equity and do not intend to switch into an equity cash position after the derivative instrument expires.

² Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 410 (1983)

Yet typically in these circumstances such disproportionate relationships are visible to shareholders via public reporting requirements and disclosure of share structures.

The linking of voting rights and economic interests is vital for corporate governance because it grants oversight of company managers to those (shareholders) who have an incentive to exercise their power to potentially create long-term value. The greater the number of shares owned, the more this incentive is amplified through a corresponding number of votes.

The explosion in the use of derivatives in finance and growth in share lending by institutions and pensions funds have resulted in the decoupling of both economic and voting rights from shares. This has created two main issues for investors – empty voting and hidden ownership – as shown below:



Source: CA Cheuvreux

The banking regulation and financial law due to be introduced in France (in 2010) is an example of regulatory efforts to tackle empty voting

The new law will require borrowers with a minimum of 2% to make a declaration at the AGM

Empty voting has negative consequences but it can be managed

Empty voting occurs where the legal interests of owning the shares and gaining voting rights is greater than the economic interest. Examples include the borrowing of shares to capture or boost voting rights in order to influence the outcome of shareholder meetings.

However, while we acknowledge the potential negative implications created by empty voting, it is for the most part a method of acquiring voting rights to effect a change over the short term and despite the avoidance of transparency for the issuing company there is some transparency in that institutional investors (who are often the lenders) will have a record of who the shares have been lent to, while borrowers of the shares and the size of their holdings are revealed when their votes are cast. We therefore believe that this issue can be managed through tighter and more controlled share lending policies, particularly the identification and recall of votes before contentious shareholder meetings.

In addition, there is evidence of regulatory efforts to combat the problem of empty voting, an example of which is the banking regulation and financial law due to be introduced in France in 2010 which will require borrowers with a minimum of 2% to make a declaration at the AGM.

II – Hidden ownership: a real threat to shareholder rights

In our view, hidden ownership whereby outside investors hold more economic ownership than votes³, represents a real threat to shareholders' rights and their long-term interests. This threat arises when hidden ownership involves the use of morphable voting rights⁴, which give outside shareholders economic ownership that can translate into voting rights.

Under current disclosure rules, such rights remain undisclosed, but they can quickly morph to include voting ownership. Therefore, we can view the triggers for hidden ownership with morphable voting rights as a situation where:

- the position is meaningful e.g. > 3% of issued equity;
- there are arrangements that allow investors to obtain legal interest (voting rights).

■ Consequences of hidden ownership

Porsche's recent failure to takeover Volkswagen is an obvious and useful case study highlighting the consequences of hidden ownership with morphable voting rights.

CONSEQUENCES OF HIDDEN OWNERSHIP

1. Lack of efficient pricing within capital markets due to insufficient information.
2. Lack of transparency on large holdings, large transactions, possible conflicts of interest and free float (creeping control).
3. Avoidance of mandatory bids at an equitable price, no takeover premium and no real exit for minority shareholders.

Source: CA Cheuvreux, European Securities Markets Experts Group (ESME) November 2009

The use of derivatives in the Porsche case destroyed value in instruments such as preference shares, which had already legitimately decoupled economic and legal interests

Lack of efficient pricing due to insufficient information

One of the arguments behind the UK Takeover Panel's decision to expand the scope of its disclosure rules to include economic interests was that this would enable shareholders to understand why share prices might be moving in a particular direction.⁵

The reality behind Porsche's use of derivatives was that it obscured the true picture of VW's free float. This was a significant concern because hedge funds which had bet on a falling VW share price, were then caught short when it became clear that Porsche owned 74.1% of the issued share capital leaving only 5.8% of shares remaining in the free float (since the State of Lower Saxony controls 20%). With about 13% of shares sold short by hedge funds, a significant short squeeze had built up, which led to an explosion in the price of VW ordinary shares as hedge funds were forced to cover short positions from a shrinking free float.

However, what is interesting in the Porsche case was its effect on instruments that offer investors (in normal circumstances) a transparent means of decoupling economic and legal rights, i.e. preference shares, whereby shareholders relinquish their rights to control the legal structure by voting in exchange for larger economic rights (dividends). What is clear is that minority investors, irrespective of whether they were holders of Porsche or VW preference shares, lost value as the price of preference shares fell sharply after the market realised the true picture of VW's control structure in terms of Porsche's ownership of both ordinary and preference shares.

³ Hu and Black, 79 South. Cal. L. Rev., supra n. 1, at p. 812.

⁴ 'Morphable voting rights' is a term coined by Hu and Black.

⁵ The Panel on Takeovers and Mergers, dealings in Derivatives and Options, Consultation Paper Pcp 2005/1, 11 (2005).

Hidden ownership can prevent corporates from identifying who owns them and who has the ability to easily obtain significant voting power

Porsche's ability to increase its economic exposure to VW without the knowledge of other shareholders...

...enabled Porsche to set the price at which it acquired its economic stake at a lower level, thereby making its proposed bid for VW less expensive

Lack of transparency and creeping control

Porsche's ability to use cash-settled derivative options to build up a hidden stake provides clear evidence that the failure to disclose economic rights weakens the ability of markets to regulate and reduce market abuse. The ability of investors to use derivative instruments to effectively trade on non-financial information could be construed as a form of market abuse. More importantly, it reduces market visibility on corporates' control structure by allowing investors to build up stakes unseen by the market while mispricing the premium paid by long-term investors to exercise their legitimate ownership rights via voting. Furthermore, lack of transparency makes it difficult for companies to ascertain not only who owns them but also who has the ability to apply significant voting power.

Hidden ownership also weakens the ownership disclosure mechanism that exists within capital markets, whereby investors can improve corporate governance via the relationship between their economic and legal interests.

Evasion of mandatory bids, takeover premium and no exit for minorities

The use of derivatives enabled Porsche to acquire morphable voting rights in VW at an agreed strike price, which in effect enabled it to potentially build up what would have been a controlling stake in VW if not for the blocking minority held by the Lower State of Saxony.

In a takeover scenario, stake-building by the offeror company is normally information that is important to other shareholders. Porsche's ability to increase its economic exposure to VW unseen by other shareholders ensured that the share price remained unaltered. This allowed Porsche to set the price at which it acquired its economic stake in VW, therefore making its proposed bid for VW less expensive.

Furthermore, despite Porsche's ultimate failure to take over VW, the resulting reverse transaction which saw VW gain control of Porsche resulted in a captive process for minority investors (particularly passive investors) who were left with limited options such as remaining a preference shareholder in Porsche or VW or divesting from Porsche and buying VW preference shares as a method of gaining cheaper economic access to VW in anticipation of the merger of Porsche and VW in 2011.

■ Examples of hidden ownership

Country	Companies	Date	Outline
Germany	SGL Carbon / Susanne Klatten / Skion GmbH	March 2009	The "Board of Management of SGL Carbon SE was informed that Skion, the investment company of Mrs Susanne Klatten, has acquired an equity stake of 7.92% in SGL Carbon SE. Skion has built positions within this percentage scope through derivative capital market instruments." Different business journals (e.g. Handelsblatt, Manager Magazin) reported that Skion had followed the example of Porsche by entering into cash-settled equity swaps. On 8 April 2008, Skion notified SGL Carbon that the voting interest in SGL Carbon AG had exceeded the thresholds of 10% and 15%. At this time the stake of Skion amounted to 16.48%. All voting rights of Skion were to be attributed to Susanne Klatten.
Germany	Porsche vs Volkswagen	October 2008	Porsche announced that it had built a direct share interest of 42.5% in its competitor Volkswagen. Porsche disclosed an additional economic interest of 31.5% by cash-settled options. Market parties had speculated on a share price fall and were short for about 13% of outstanding shares. The closing of these positions led to a price explosion of the Volkswagen shares. In order to improve liquidity, Porsche settled 5% of its position into cash, thereby profiting from the market disorder caused by itself.
Germany	Continental vs Schaeffler	July 2008	Schaeffler built an economic interest of 36% in Continental by entering equity swaps with some banks before it declared a public offering for the outstanding capital of Continental. Schaeffler was exempted from launching a mandatory bid, since it had made a voluntary public offer and wanted to pay a fair price. The German regulator Bafin ruled that the build-up of an economic interest by cash-settled financial instruments did not need to be notified under current German law.
Switzerland	Laxey Partners vs Implenla	2007	At Implenla's AGM Laxey Partners showed a position of 24% of outstanding shares without having notified the Swiss regulator. Swiss newspapers speculated that the interest had been hidden by derivatives constructions such as cash-settled options.
Switzerland	Victory vs Sulzer	2007	The industrial company Sulzer was apparently dominated by a group of Russian and Austrian investors who held a 32% interest in the company. Part of the interest (14%) was held through a cash-settled option construction, secretly built up by an investment vehicle called Victory.

Source: CA Cheuvreux

III – Solving the hidden ownership problem

■ Poison pill adaptation: the market's answer

Companies faced with continuing uncertainty over disclosure of derivatives...

... can amend or introduce poison pills that include economic ownership, thereby capturing the use of cash-settled derivative options

The current vacuum at European level may inevitably lead to market-based solutions to combat the possibility of creeping control through hidden ownership, which we expect will continue to threaten good corporate governance in Europe. We believe that listed companies may increasingly view poison pills as a method of preventing outside investors from obscuring their control structures. While standard poison pills are designed to be triggered once a shareholder has crossed a particular ownership threshold in terms of voting interests, they could be easily amended to include economic ownership.

The use of poison pills by corporates in both Europe and the US has for many years been in decline. In the US this was mainly due to pressure from institutional investors, corporate governance proponents and proxy voting agents such as Risk Metrics who adopted voting policies recommending that shareholders vote negatively against corporations that adopt or renew shareholders rights plans. Furthermore, in Europe the role of the European Commission was also significant as the European Takeover Directive provided a legal framework for takeovers in the EU.⁶ Nevertheless, companies in the US and Europe can generally implement a poison pill if they seek shareholder approval either before or after the takeover event.

We believe that the increasing use of derivatives by hedge funds and activist investors means that cash-settled derivatives will remain a significant option in public takeovers and proxy fights. In our view this will necessitate a response from corporates, who may turn to poison pills as the best available solution to the problem of hidden ownership.

We believe the US provides a good example of this where in recent years, with poison pills undergoing a modernisation process via the inclusion of shareholder-friendly features such as prior shareholder approval and shorter plan duration.

These initiatives have ensured that poison pills fall within RiskMetrics poison pill policy, which recommends withholding votes from directors who adopt or renew poison pills lasting 12 months or more, without shareholder approval.

However, the most significant development in takeover defences in the US is the inclusion of language that captures synthetic positions such as equity derivatives within the triggers of poison pills. The inclusion of such provisions is a direct response to the changing nature of equity ownership in the US, which created a need for corporations to ensure transparency on ownership.

The case of CSX was a clear signal to US corporations of the growing use of equity derivatives by investors and the need for defensive measures. In 2008, two UK activist investors, The Children's Investment Fund (TCI) and 3G Capital, attempted to use total return swaps during 2008 as a method of gaining economic exposure and subsequent voting rights to appoint five directors to the CSX board. In our view, there is a direct correlation between the sharp increase in derivative triggers within US poison pills and the growing use of equity derivatives to build up hidden stakes in US corporations.

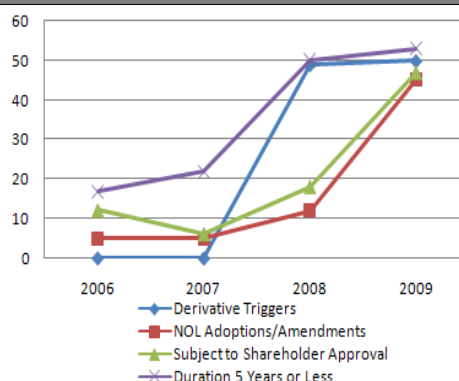
⁶ The EU Takeovers Directive (2004/25/EC) was adopted on 21 April 2004 with a requirement for all member states to implement it from May 2006. The Takeovers Directive lays down, for the first time, minimum EU rules concerning the regulation of takeovers of companies whose shares are traded on a regulated market.

Reference to derivative triggers in US poison pill language increased significantly between 2007 and 2008

The use of poison pills with a derivative trigger would potentially benefit shareholders by delaying the ability of outside investors to effect a change in control that is hidden from other investors...

... but with potential risks for minority shareholders

MODERNISATION OF POISON PILLS IN THE US



Source: SharkRepellent.net

While the number of European companies with specific poison pills remains relatively low compared with the US, it is clear that specific poison pills that have been shareholder approved and that recognise and are triggered by equity derivatives are not only permissible but could be viewed as protecting and maximising shareholder value, given current economic markets.

Therefore if uncertainty over the implementation of European regulation to combat derivatives continues, then European companies may seek to extend the control and economic ownership rules in their articles of association to include the use of cash-settled derivatives, or alternatively companies may seek short-term approval from shareholders to implement poison pills that capture derivative positions.

The benefit to shareholders of this approach would be that it would delay the ability of external investors to potentially effect a change in control that has not been considered by all shareholders whilst potentially creating a level playing field for other investors to determine whether they want to potentially gain control.

However, while poison pills might solve the problem of hidden ownership, the consequences of an increase in their use would be negative to the rights of shareholders over the long term, particularly minority investors given the control poison pills give to management in the event of a takeover scenario.

■ Legal consequences of derivatives may be effective deterrent

There is a clear legal risk to using derivatives under which the investment services provider or bank offering this type of product can be perceived to be acting in concert or worse if the use of the cash-settled derivative is perceived to be fraudulent.

■ Increased legal and reputation risk for service providers...

The increased scrutiny and reputational risk for banks participating in derivative transactions that can leave them exposed to legal action ensures that most banks are already mitigating their liabilities. The most effective response is to implement strict control of "warehousing structures" to prevent any suggestions by regulators that they are acting in concert (by voting the underlying shares in line with the derivative holder) by allowing investors to gain influence over public companies while avoiding disclosure.

The ability of investment banks to easily create dividend contracts on underlying shares...

... means that their use remains economically practical

A European regulatory response to ensure transparency is on the way, but any regulation is unlikely to be implemented before 2012

Cash-settled equity derivatives remain an attractive option in public takeover and proxy fights if structured correctly

As such, cases of undisclosed increases in holdings as a result of derivatives do not appear to be widespread. The "buzz" around such cases and the legal consequences that can sometimes arise are demonstrated by investors in Implenia (Laxey Partners) & Volkswagen Group (Porsche), currently facing civil and now criminal proceedings for their use of derivatives. Therefore it can be argued that given the potential legal deterrent it is far from obvious that other investors will embark on a course of using derivatives as method for gaining creeping control.

... but practicalities of proving derivative misuse make it a viable option

However, until there is a universal approach to disclosure by the US and Europe (harmonisation within European member states will be an added problem) we believe the use of derivatives to create hidden stakes will exist as a "known unknown" in that it is clear that it can be done even if it remains unclear how often it actually happens. We also believe that legal authorities or regulators will find it difficult to prove that multiple banks offering derivative positions are acting in concert.

In our view, the ability of investment banks to easily create dividend contracts on underlying shares means that the use of derivatives remains economically practical given the extent to which it allows an external investor to set the price (via the derivative contract) at which it builds its stake. As such, we believe the legal risks for banks may not be enough to prohibit the use of derivatives.

■ Regulatory response the obvious answer

In the absence of a European consensus, individual member states have to varying degrees attempted to introduce reporting obligations to reduce the potential impact of derivatives on the control structure of listed companies.

However, the obvious solution to the problem of hidden ownership would be to extend notification rules regarding economic exposure to cash-settled derivative options within the disclosure regime of the European Transparency Directive (TD). This would require derivative positions to be reported separately from underlying share positions, whether long (positive) or short (negative), for all listed companies in the European Union.

This would enable companies to ascertain shareholders' legal interest as well as their economic interests, which can provide different motivations for investors. The TD is likely to be modified after the current CESR consultation⁷ has been completed but any modifications are unlikely to come into force before 2012.

Until a European regulatory response is formulated, investors and companies in markets outside the UK and Switzerland are subject to the threat of derivatives designed to hide ownership and potentially introduce creeping control. In addition, investors in markets outside the UK and Switzerland will also be at threat. We therefore believe that cash-settled equity derivatives remain an attractive option in public takeover and proxy fights if structured correctly.

⁷ The current CESR (Committee of European Securities Regulators) consultation to extend major shareholding notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares is ultimately aimed at amending the Transparency Directive.

Beyond transparency, complexity is also an issue

The current momentum for ensuring better corporate governance control tells us that any equity derivative that potentially alters the underlying shareholder structure presents a risk. Even with further transparency, these sophisticated structures could be perceived as too complex for minority shareholders. The controversies surrounding the recent Goldman Sachs case tells us that the "complexity of derivatives" instruments, when not understandable by the parties that they potentially impact, are at risk of further regulatory control.

Banks again, may move ahead of regulation in order to mitigate their liabilities and prevent reputational risks.

CURRENT ACTIONS TAKEN BY REGULATORS ON EQUITY DERIVATIVE DISCLOSURE

Country	Implementation date	Outline
UK	2009	Disclosure of (gross) long positions on cash-settled derivatives from 1 June 2009 onwards. It requires reporting once the threshold of 3% has been reached, aggregating both the derivative transactions and any actual holdings of the voting shares.
Netherlands	2009	Consulting with Netherlands Authority on financial markets to decide whether (and how) the legal substantial holding disclosure provisions should be extended to cash-settled derivative positions.
France	2009	The main change consists in expanding the scope of information with respect to cash-settled equity financial instruments (long positions) which must be disclosed only when an obligation of disclosure (ie due to the holding of shares and entitlements to acquire shares) is triggered. This new disclosure is to be effected by way of a separate notification and not by way of an aggregation with holding of shares.
German	n/a	No action to date.
Switzerland	2007	The Swiss regulator extended the scope of notification rules at the end of 2007. Disclosures on cash-settled derivatives only are rare; in many cases such disclosures are done in connection with disclosures of other shareholdings in the respective companies.
Italy	2009	The national authority Consob recently issued a public consultation on the topic.

Source: CA Cheuvreux

Most of these trades are hard to track as they are made via OTC products...

... but trading operations to hedge the deal may be tracked via listed options

IV – Spotting hidden ownership

A huge difference between open interest and equity volumes is an alert

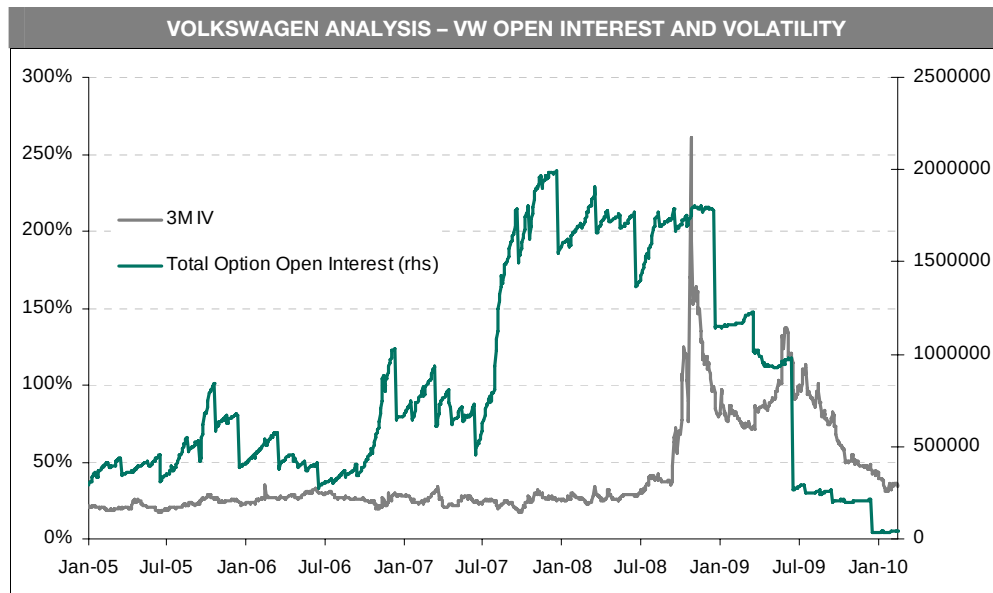
Most of the corporate derivatives trades are made via OTC derivatives and delta one products with investment banks. This means the information is not public and thus not easy to obtain and analyse. Operations are performed over long periods of time in order to smooth the volume impacts. Nonetheless, banks may have to hedge their positions with stocks and options, and if the volume involved in the operation is too large, they may have to disclose ownership to corporates and regulators.

If this is not the case, we can try to detect this kind of trade via listed options open interest (and cash equity volumes), even if hedging operations are smoothed over time.

As single stock options are usually not very liquid, the impact of corporate derivatives can be huge, especially for M&A deals. The hedging of large amount of options is not easy due to the size of the exposure or sensitivities. These trades, when finally disclosed, have a huge impact on the underlying price (delta impact) but even more on derivatives, mainly via gamma (sensitivity to very short-term underlying moves) and vega (sensitivity to underlying volatility).

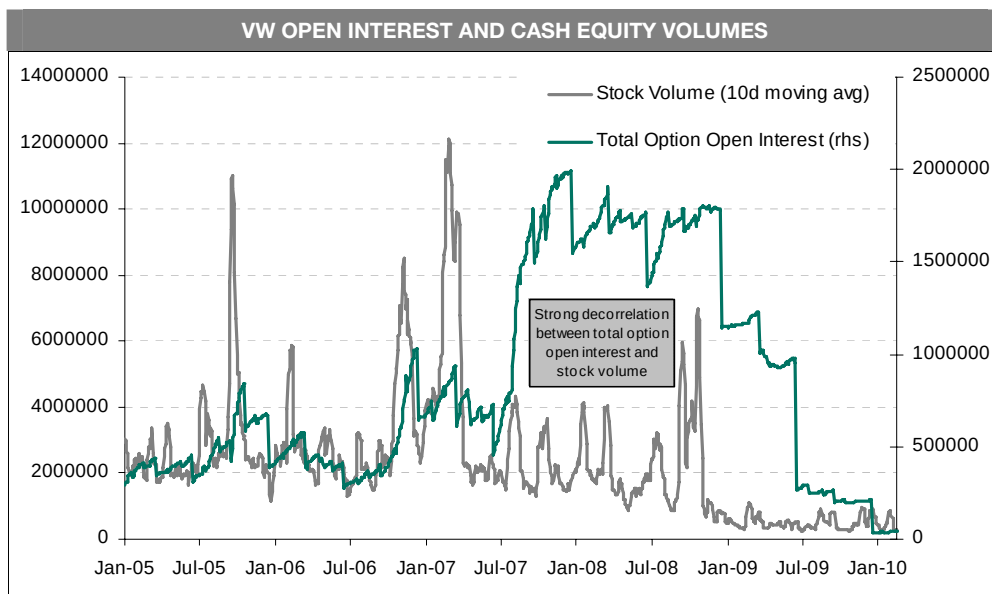
These deals affect cash equity, derivatives, convertibles and repo markets and lead, in extreme cases, to the dislocation of these markets.

We have analysed the two main recent stories, Volkswagen (VW) and Continental, to see whether hedging of the corporate deals by banks is visible on cash equity or derivatives markets.



Open interest on VW increased significantly from July 2007, more than one year before the market realised the short squeeze on VW. Volatility exploded only when the short squeeze was disclosed in October 2008.

On VW, a decorrelation between stock volumes and options open interest could have been detected more than one year before the short squeeze

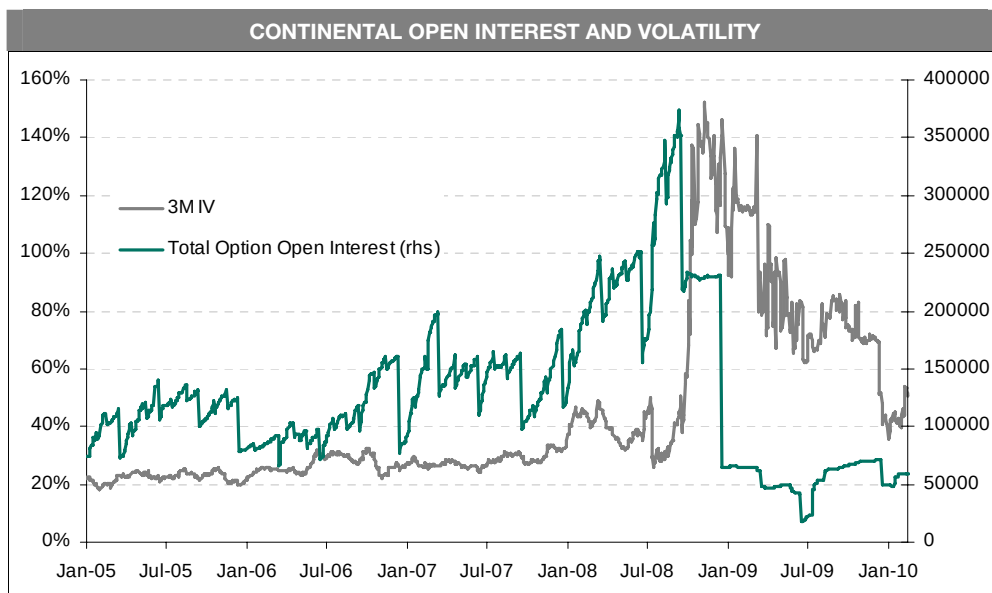


Source: Bloomberg

From July 2007, in spite of the open interest increase, cash equity volumes were stable and rather low. It was then impossible to monitor and anticipate the delta hedging from the equity volume analysis. However, the "de-correlation" between the open interest and the equity volumes is quite interesting to note.

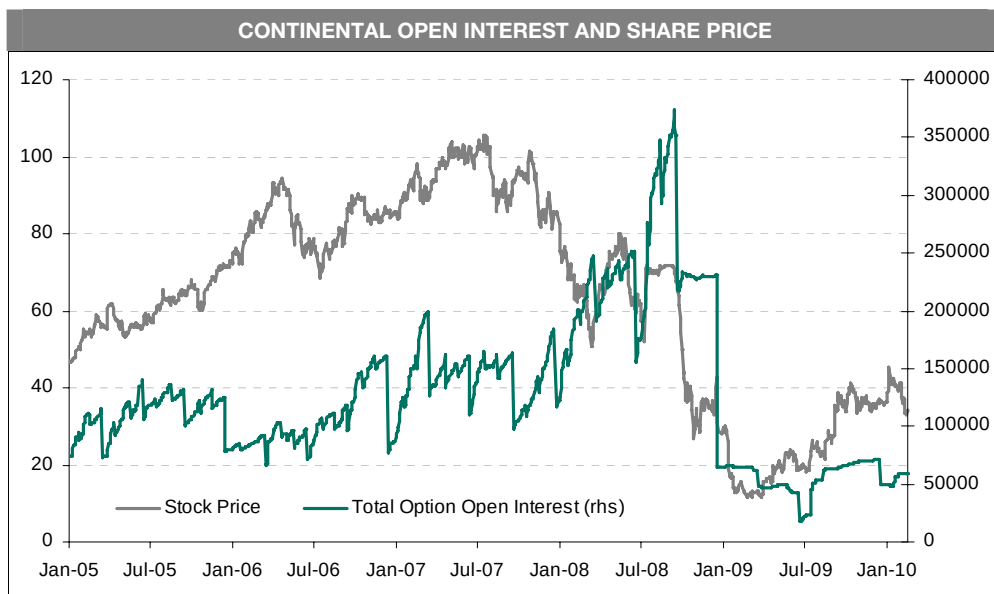
Continental analysis

On Continental, the situation is less pronounced. Open interest increased a little before the announcement by Schaeffler in July 2008, and so ahead of volatility.

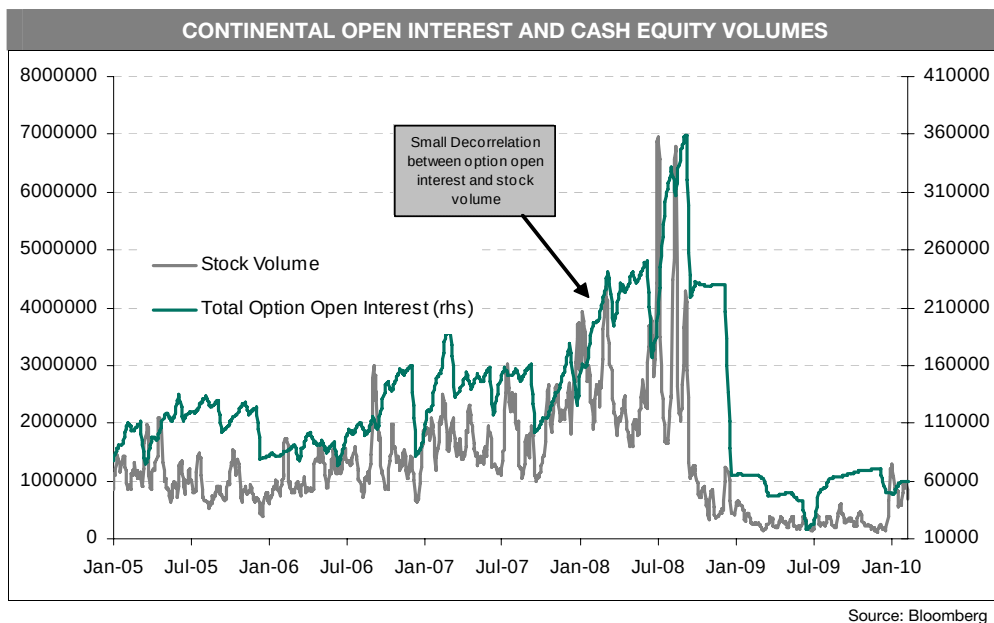


Source: Bloomberg

The peak of the open interest increase is then coincident with the share price jump, and the open interest decrease is then parallel to the share price collapse post Lehman and balance sheet worries of the combined Continental-Schaeffler group.



The decorrelation between the open interest and the cash equity volumes can be observed before the announcement; however, this is not massive.



On Continental, the decorrelation was less visible and was a shorter notice signal

Convertible bonds usually have a ratchet clause that protects bondholders' interests in the event of a takeover

■ Impact of hidden ownership on other financial instruments

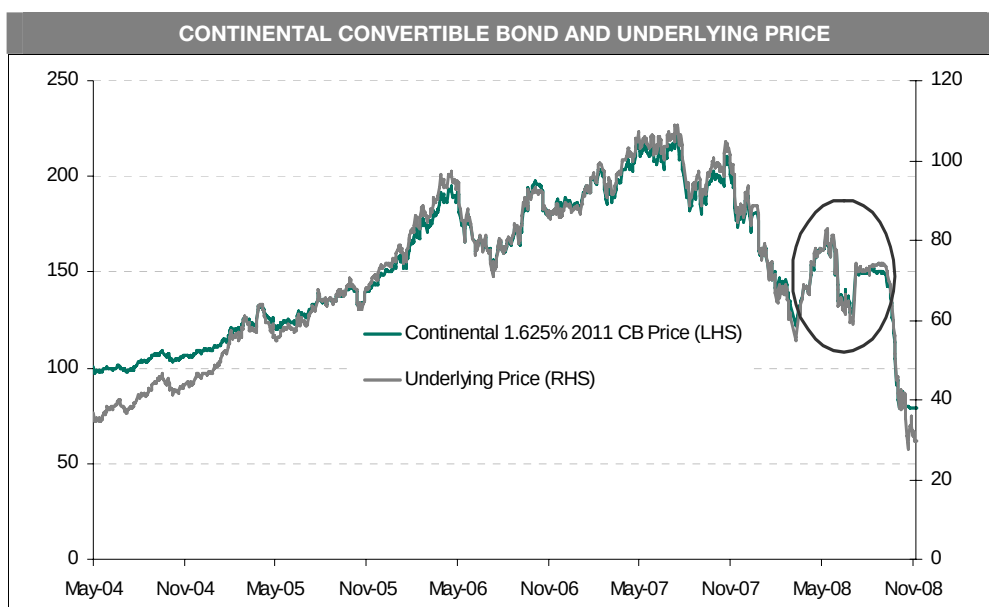
Convertible bonds (CBs): the example of the Continental convertible

Convertible bondholders represent a certain kind of minority shareholder. As such, they must benefit from the "upside" offered during a takeover.

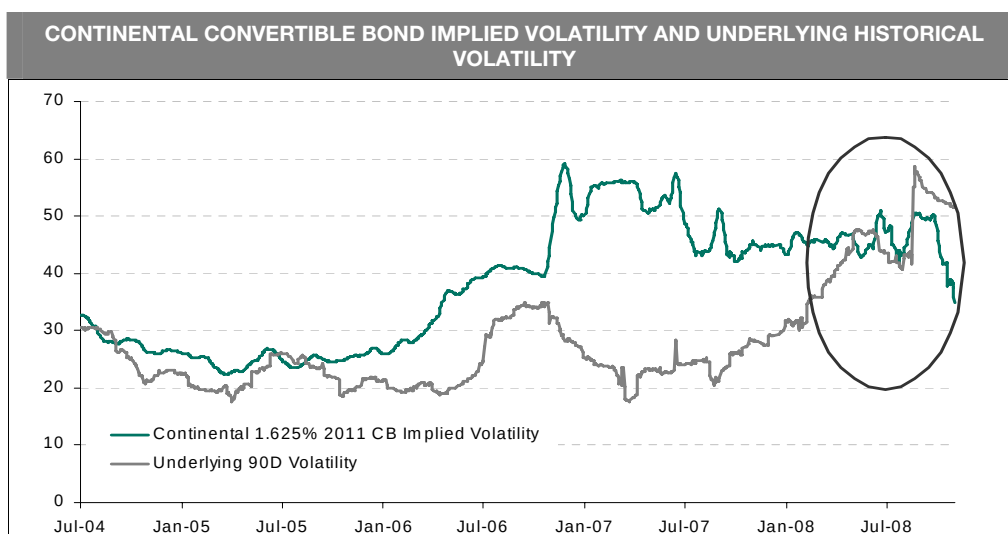
The mechanism called "Ratchet" is a tool for CB investors to have "upside participation". Thanks to this clause, investors receive a compensation for the control premium offered to shareholders during a takeover.

The Ratchet leads to an increase of the conversion ratio: CB investors receive more shares per CB held and their conversion price (the strike) is then decreased.

This ratchet is activated if a "trigger" is exceeded: the percentage of the capital of the firm to be bought for a change of control to be declared.



Source: Crédit Agricole CIB



Source: Crédit Agricole CIB

In this case, the nature of the whole operation (via equity swaps) was the cause for the non activation of the ratchet, thus penalising CB holders

In the above example of Schaeffler, CB investors were penalised as the takeover was made via equity swaps, the trigger was activated and investors did not benefit from the ratchet clause. Just after the announcement of the takeover, the CB's implied volatility spiked, but then decreased sharply as this indirect takeover did not activate the ratchet. CB investors massively converted their CBs into shares (the CBs were in the money), and the clean-up call (15%) was activated.

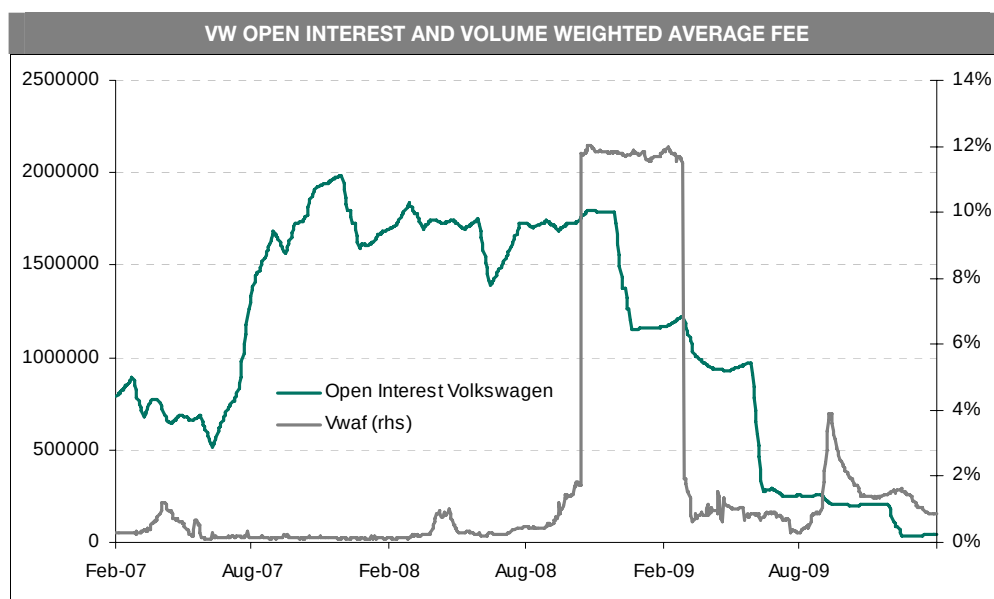
Parity was boosted by the bid, but investors did not receive "a boosted conversion ratio" via the ratchet as is normally the case with M&A situations (remember that CB investors pay a conversion premium during the issue of the CB and the ratchet is there to compensate for this conversion premium by increasing the conversion ratio).

■ The repo market

We have analysed as well the impact on the repo market with the two stories Continental and VW. In those two cases, the increase of fees was coincident with the public announcement of the deals.

In the case of Volkswagen, the short squeeze was huge and the quantity of loans collapsed immediately. Borrowing fees were up to 12%.

Tracking the repo market does not provide any advanced indication of what is going on

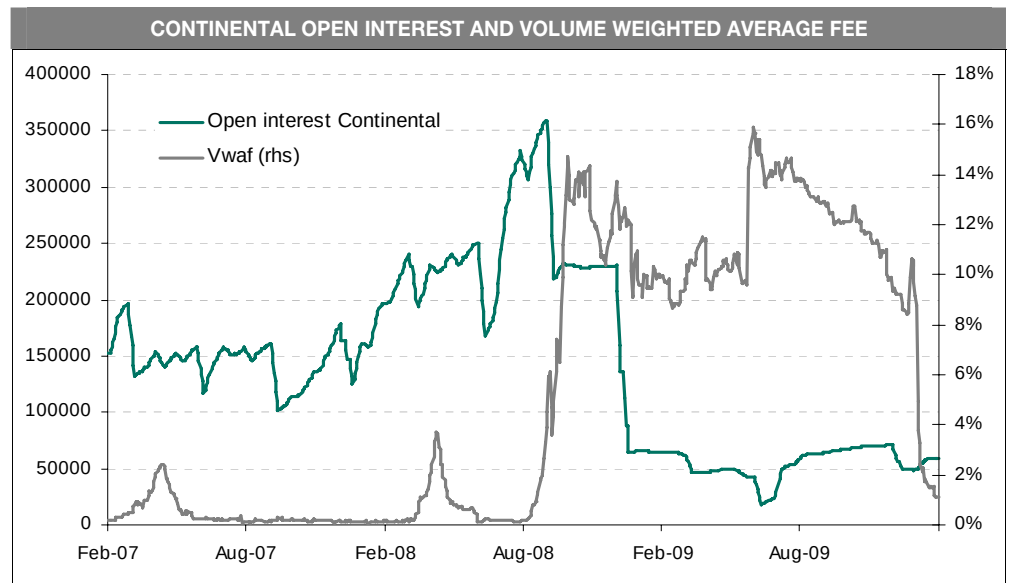


Vwaf = volume weighted average fee

Source: Crédit Agricole CIB

In the case of Continental, the average fee to borrow stocks exploded when the deal was disclosed (16% on the graph, but even 20% some days), some months after the increase of open interest. These fees remained high in spite of the decrease of open interest, and only fell at the very end of the deal.

However, we can
nonetheless observe
the dramatic upward
effect on fees



Efficiency of engagement is at stake, but the importance of the issue is hard to estimate

The absence of voting by investment banks eliminates these shares from the universe of available votes

V— From "hidden" to "silent" ownership

■ A governance issue for major index companies' constituents

The use of synthetic instruments to replicate or hedge equity performances is growing to such an extent that it has become another issue for corporate governance. While "hidden" ownership mostly focuses on derivatives used by corporates themselves or predator funds, when used by investors these derivatives pose the problem of "silent" ownership. The high concentration of these derivative plays on the major equity indices leads to a larger pool of "silent" shareholders who do not own the underlying shares nor their subsequent ownership responsibilities, thus making engagement by active investors less efficient for these companies.

The lack of transparency disclosure requirements on stock ownership makes it difficult to estimate how significant these silent owners are and who they are, since most of the disclosed ownership positions are done at depositary bank level.

We believe that two types of financial products potentially drive "silent" ownership:

- passive management, when using "synthetic replication" (70% of market practice);
- structured equity derivatives, either delta or leveraged.

For both of these types of products, the "synthetic" instrument held by investors is a "physical" counterparty held by investment banks who are (potentially) able to vote based on the underlying shares since as owners of the shares they have no restriction.

However, one of the main attractions for the provider of these types of structure is to benefit from the trading book exemption (whereby the provider is not required to disclose the shareholding to the issuer). Moreover, the Transparency Directive clearly says that "the credit institution or investment firm ensures that the voting rights attaching to shares held in the trading book are not exercised nor otherwise used to intervene in the management of the issuer". In the words of the law firm Debevoise & Plimpton, the absence of voting by investment banks "eliminates the shares from the universe of available votes".

■ Passive management: a "governance-free" investment?

Our definition of "passive" in the context of this research refers to an investment structure that has an objective to replicate the performance of a benchmark instead of outperforming it. In our view, whether it involves the tracking of market indices or the use of synthetic structures to replicate equity performance, such an investment approach can be viewed as a low-cost strategy compared with active management, and as such a "low-governance" one.

Passive index management represents only around 15% of equity asset under management but is highly concentrated on major indices' constituent companies; these are also the most used underlying for equity derivatives structured products. This concentration means that on average between 20% and 30% of these companies' outstanding shares are held by passive investors.

In this context, the optimisation of stock lending by indexed funds based on synthetic replication and not the physical requirement to own the underlying shares represents a practical obstacle to active ownership.

Assets of exchange traded funds (ETFs) and exchange traded products (ETPs) surpassed \$1,000bn (£659bn, €759bn) near end-2009

Furthermore while all passive management approaches are not based on synthetic replication, in the ETF market (the most important segment for passive management) it usually varies according to the fund sponsor.

Asset managers tend to physically own their shares while ETFs being sponsored or associated with investment banks tend to use synthetic replication, which represents the largest market share for ETFs. As a result, the growing market share of passive management leads to the potential abandoning of governance control to the management of major indices constituents and represents, in our view, a threat to corporate governance.

Index mgmt can make improving governance harder, but size matters!

We believe the ability of pure index players to carry out effective active ownership by utilising their shareholder rights and position to influence the behaviour of the company is may be limited by the following factors:

- They may be viewed as index players by corporates, which makes engagement to improve governance more difficult given the inability of investors to exit the stock if engagement is unsuccessful.
- The number of companies in the index makes resources a deciding factor in terms of where engagement and voting can be most efficiently and effectively deployed.
- The size of the holding.

Therefore smaller index players may find that a combination of the above factors plays a part in their ability to be effective in improving governance within their index. However, we also believe that the size of passive holdings can increase the influence of indexed funds at critical moments within a corporate's calendar: specifically the annual general meeting where particular actions such as amending the articles of association or approving a change in control require a super majority vote. It is in such scenarios that larger index players are able extract significant influence from corporates.

Governance-free investment

Governance practitioners have pointed out that indexed management using synthetic constructions that operate as low-cost vehicles and afford no voting rights could be viewed as an attractive alternative for large asset managers who own shares.

As such, the consequence of increasing investor interest in passive management via synthetic index funds such as ETFs is a lack of ownership by investors who may simply not realise that they are investing in a governance-free vehicle.

Perspectives?

We see a first step towards combating silent ownership through synthetic replication would be if an increasing number of asset owners specifically required their mandates to be invested only in index funds that physically own the underlying shares.

A second step, often championed by governance practitioners, would be the introduction of some form of levy on the manufacturers of ETF derivative indices, which would be paid out in the form of a dividend to those investors who had purchased shares and had therefore performed their ownership responsibilities in terms of voting and engagement.

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