Harvard Law School Forum on Corporate Governance

SUPPORTED BY: pwc

Governance and the Decoupling of Debt and Equity: The SEC Moves

Posted by Henry T. C. Hu (University of Texas), on Monday, November 7, 2022

Editor's note: Henry T. C. Hu is the Allan Shivers Chair in the Law of Banking and Finance at the University of Texas Law School. This post is based on his recent paper, forthcoming in *Capital Markets Law Journal,* and is part of the Delaware law series; links to other posts in the series are available here.

"Decoupling"—the unbundling of the rights and obligations of equity and debt through derivatives and other means—has posed unique challenges for corporate and debt governance. Corporate governance mechanisms, such as shareholder voting and blockholder disclosure, have faced "empty voting with negative economic ownership" and "hidden (morphable) ownership" issues. Debtor-creditor contract-based interactions have faced "empty crediting with negative economic interest," "hidden interest," and "hidden non-interest" issues. In 2006, the initial version of an analytical framework for decoupling was introduced. In that decade, foreign regulators, Delaware and other substantive law authorities, and private ordering started responding.

In 2021 and 2022, the Securities and Exchange Commission (SEC) voted out proposals directed at decoupling, as well as other proposals that may affect decoupling. My article, **Governance and the Decoupling of Debt and Equity: The SEC Moves** (forthcoming in *Capital Markets Law Journal*, 2022), is the first work to: (1) analyze the SEC proposals as a whole, propose significant changes, and offer ideas for enhancing the proffered cost-benefit analysis (CBA); and (2) situate the prospective SEC role with the roles that substantive law authorities and private ordering are already playing.

The SEC Proposals and the CBA

The Article urges changes to the SEC proposals, some of which are described in this post. It also offers two new avenues for enhancing the robustness of the SEC's CBA against possible challenges in the D.C. Circuit.

The "hidden (morphable) ownership" strategy refers to the use of holdings of cash-settled synthetic equity to avoid large blockholder disclosure requirements of the Exchange Act Section 13(d) variety. Section 766 of the Dodd-Frank Act effectively prevents the SEC from requiring that holdings of cash-settled equity swaps—the key synthetic equity historically used in the strategy—be counted toward the Schedule 13D 5% filing threshold. As a result, the SEC proposed a complex, bifurcated regulatory architecture consisting of two discordant disclosure regimes for synthetic equity holdings. One regime is for cash-settled synthetic equity *other than* cash-settled equity swaps (per a revised Schedule 13D proposed in SEC Release 33-11030). This regime is designed to address this decoupling strategy, with a filing date requirement set at five days intended to strike the right balance between promoting market efficiency/transparency and

incentivizing shareholder activism. Technically, proposed Schedule 13D continues to use the 5% filing threshold; however, the proposed, highly expansive definition of "group" affects matters considerably. The regime for holdings of cash-settled equity swaps (per a new Schedule 10B proposed in SEC Release 34-93784) is not designed to address this decoupling strategy or corporate governance generally. Instead, largely animated by the Archegos debacle, the Schedule 10B regime's mindset centered on financial stability and fraud and manipulation. Based on this mindset, Schedule 10B has a one-day filing requirement. Filing would be triggered by, e.g., a cash-settled equity swap position in a notional amount of $300,000,000.

The proposed SEC approach to synthetic equity disclosure has two core weaknesses. *First*, the "situs" of cash-settled equity swaps within the architecture and the "silo" mindset that resulted in the associated one-day filing requirement would upset the vital balance between enhancing market transparency/efficiency and incentivizing shareholder activism. *Second*, unjustified asymmetries in regulatory treatment as to thresholds and filing dates would arise across categories of synthetic equity holdings and between synthetic equity holdings and direct equity holdings. Direct and certain synthetic equity holdings face a Schedule 13D 5% threshold. Cash-settled equity swap holdings of $300,000,000—a mere 1% of a company at the median capitalization of the S&P 500—would trigger Schedule 10B.

The Article offers a partial solution that, despite Dodd-Frank Section 766, would better incentivize activism and reduce the asymmetries. The solution is, for cash-settled equity swaps, that the filing date and threshold requirements for the proposed Schedule 10B should incorporate by reference the filing date and threshold requirements of the proposed Schedule 13D.

Another set of changes the Article proposes relates to the SEC's primary effort to address "empty creditors with negative economic interest" (aka "net short" creditors). In this connection, the SEC alluded to a media story on Windstream/Aurelius. However, the Article shows that the proposed disclosure requirements could be triggered when empty crediting is impossible even in theory. Merely holding credit default swaps (CDSs) in the requisite amount could trigger filing, without any concurrent debt or equity holdings. This aspect of the requirements ignores the necessary conjunction of troublesome incentives from certain CDS holdings with the power flowing from the control rights associated with debt or equity holdings. The Article proposes changes.

The SEC's proposals are susceptible to CBA-based challenges. For example, broadly speaking, some have questioned the existence of the hidden (morphable) ownership phenomenon. The Article shows how judicial findings in certain litigation involving U.S. persons or U.S. courts can help address this claim. Similarly, the SEC should consider why and how so many foreign jurisdictions—indeed, all the ones examined (Australia, Canada, France, Germany, Hong Kong, Ireland, Italy, Netherlands, Switzerland, and the United Kingdom)—have addressed hidden (morphable) ownership.

The Roles of Substantive Law Authorities, Private Ordering, and the SEC

Substantive-law-centered authorities, such as the Delaware legislature and courts, are addressing empty voting issues. Delaware courts have been receptive to the analytical framework for decoupling, as evident in the 2010 Delaware Supreme Court *Crown Emak* case (992 A.2d 377 (Del. 2010)) evaluating a third-party vote buying agreement based on the alignment of economic

interest and voting interests. More recent cases include this year's Vice Chancellor Laster opinion in *Hawkins v. Daniels*, 273 A.3d 792 (Del. Ch. 2022), on whether an irrevocable proxy arrangement ran with the sale of a corporation's majority shares. The most dramatic example of judicial intervention to curb the voting rights of an empty voter with negative economic ownership occurred in British Columbia, in the proxy fight between TELUS Communications and hedge fund Mason Capital Management. *TELUS Corporation (re)*, 2012 BCSC 1919 (2012).

Private ordering has responded to equity and debt decoupling. The rise of "second generation" advance notice bylaws and poison pills has been directly attributed to concerns about equity decoupling. As for debt decoupling, the use of "net short" provisions in debt agreements increased following Windstream/Aurelius.

Because of externalities and other reasons, private ordering alone is insufficient to address empty crediting. The SEC has a vital role. As for empty voting, the SEC can help courts and private ordering in identifying the presence and extent of empty voting.

Conclusion

Properly addressing decoupling is a difficult task. The issues are complex: corporate governance, investor protection, market transparency, financial stability, and other considerations can run in different directions. The techniques used for decoupling are constantly evolving, and often in ways opaque to outside observers. The SEC is moving toward the role it must play. I am confident that the SEC is up to the task.

The complete article is available here.

Governance and the decoupling of debt and equity: the SEC moves

Henry T. C. Hu*

Key points

- A 2006 article introduced the concept of 'decoupling', a phenomenon made possible by the derivatives revolution, and an associated analytical framework. Decoupling refers to how a corporation's equity and debt can be broken up by third parties, often secretly and on a massive scale. This unbundling of rights and obligations—eg, the separation of economic interests and voting rights—has profound consequences for the core market-based and legal mechanisms of corporate and debt governance.
- In a series of 2021 and 2022 releases, the SEC proposes addressing certain kinds of decoupling: eg, 'empty creditors with negative economic interest' and 'hidden (morphable) ownership'. These extreme empty creditors have incentives to see harm come to their borrowers because of their credit default swap positions and have the control rights from their debt agreements to cause them harm. 'Hidden (morphable) ownership' may enable activists and others to avoid large blockholder disclosure rules of the traditional Exchange Act Section 13(d) variety through cash-settled equity swaps.
- This article considers these SEC proposals—and the important responses to decoupling by ten foreign jurisdictions, substantive corporate law authorities (eg, Delaware courts), and private ordering.
- The article begins by introducing the reader to the analytical framework for decoupling and some major aspects of the SEC proposals. The article finds it encouraging that the SEC is moving but shows that fundamental changes to the proposals are advisable. In addition, the article offers ideas for enhancing the cost–benefit analysis essential to the rulemaking surviving likely court challenges.

INTRODUCTION 412
I. DECOUPLING AND DEBT AND CORPORATE GOVERNANCE 418
A. Overview 418
B. Equity Decoupling: Empty Voters, Empty Voters with Negative Economic Ownership, Morphable Ownership and Hidden (Morphable) Ownership. 419
C. Debt and Hybrid Decoupling: Empty Creditors, Empty Creditors with Negative Economic Interest and Hidden Interest/Non-Interest. 421
II. HIDDEN (MORPHABLE) OWNERSHIP: THE SEC'S PROPOSED ROLE. 423

* Professor Henry T. C. Hu holds the Allan Shivers Chair in the Law of Banking and Finance, University of Texas Law School. I appreciate the guidance and encouragement of Jeff Golden from the start of my derivatives-related research decades ago. This article is based in part on a lecture at Trinity College Dublin School of Law and Trinity Business School and I benefited from the insights of Professor Blanaid Clarke and the Commentator, Colm Kincaid, Director of the Securities and Markets Supervision, Central Bank of Ireland (17 October 2019). I have also benefited from a meeting with the UK Financial Conduct Authority (14 October 2019) and a conference call involving the US Securities and Exchange Commission, the US Commodity and Futures Commission, and the UK Financial Conduct Authority (1 October 2019). Lei Zhang, Conor Guest, Alex Rigby, Michael Steelman and Scott Vdoviak provided excellent library and research assistance. Professor Hu was the founding Director of the US Securities and Exchange Commission's Division of Economic and Risk Analysis (formerly called the Division of Risk, Strategy, and Financial Innovation) (2009–2011), and he and his staff were involved in certain matters discussed in this article.

© The Author(s) (2022). Published by Oxford University Press. All rights reserved.
For permissions, please email: journals.permissions@oup.com
https://doi.org/10.1093/cmlj/kmac021 Accepted 06 October 2022

A. Overview: Legal Archaeology and the SEC's Proposed Disclosure Architecture. . . .423
B. The SEC's Proposed Bifurcated Architecture: The Revised Schedule 13D Regime and the New Schedule 10B Regime 426
1. Scope 426
2. Disclosure Threshold 428
3. Filing Date 429
C. Toward a Firmer Foundation for SEC Intervention 430
1. Overview 430
2. Litigation Involving US Entities or US Courts 430
3. Foreign Regulators: Australia, Canada, France, Germany, Hong Kong, Ireland, Italy, Netherlands, Switzerland and the United Kingdom 432
Matrix: Comparative Treatment of Cash-Settled Equity Derivatives Holdings
D. How the SEC's Approach Fails to Address Hidden (Morphable) Ownership and Undermines Corporate Governance: The Promise of an Alternative Approach 445
1. Overview 445
2. The Situs/Silo Problem: The Subjugation of Hidden (Morphable) Ownership Goals 446
3. The Direct–Synthetic and Synthetic–Synthetic Asymmetries 449
4. A Second-Best Alternative 451
III. EMPTY VOTING, EMPTY CREDITING AND HIDDEN NON-INTEREST: THE SEC AND OTHER PLAYERS 452
A. Overview 452
B. Empty Voting and Corporate Governance 453
1. The SEC Proposals and Empty Voting 453
2. Delaware Courts and Other Substantive Corporate Law Authorities and the Contributing Role of the SEC 455
3. Private Ordering 458
C. Empty Crediting, Hidden Non-Interest and Debt Governance 460
1. The Key Empty Crediting Concern: Perverse Incentives in Tandem with Control Rights 460
2. The SEC's Proposed Approach and a Proposed Modification 461
3. Private Ordering and the Vital Role of the SEC 464
CONCLUSION 466

Introduction

The modern derivatives revolution is largely associated in the public mind with the potential in the use of such products for risk management and the challenges they pose to financial stability. The 2008 global financial crisis (GFC), the 2010 Dodd–Frank Act response and the statute's sprawling, decade-plus implementation still loom large, especially at financial institutions and prudential regulators.

For ordinary corporations, however, the potential and challenges associated with a less noticed, fundamentally different, use may be more relevant today. A few years before the GFC, sophisticated market participants began to profit from using derivatives and other means to, in effect, break up the building blocks of the corporate form: equity and debt. The unbundling of the rights and obligations of these building blocks posed unique challenges for longstanding mechanisms and contractual practices central to the governance of corporations.

In late 2021 and early 2022, after 15-plus years of quiescence, the Securities and Exchange Commission (SEC) suddenly voted out a series of proposals that respond to or will otherwise affect this phenomenon. This article considers the SEC's proposed role and its relationship to the roles already being played by private ordering and substantive corporate law authorities. I applaud the SEC's overall decision to begin addressing decoupling but urge major changes to the proposals.

A 2006 academic article that I co-authored introduced the concept of 'decoupling' to refer to this unbundling phenomenon and offered an analytical framework and associated terminology.[1] The article and subsequent extensions and refinements of the framework showed how the phenomenon posed unprecedented complexities for classic law-based and market-based mechanisms of corporate governance as well as the classic web of contract-based interactions of creditors and firms that define what can be referred to as 'debt governance'.[2] Equity and debt decoupling, as well as the combining of equity and debt decoupling ('hybrid decoupling'), unquestionably have private and social benefits. But a dark side exists.

With respect to the central market-based mechanism for corporate governance—the market for corporate control—decoupling could undermine the robust informational base essential to that market's operation. For instance, in the USA and elsewhere, certain equity derivatives were used to try to avoid large blockholder disclosure requirements of the

1 Henry TC Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 So Cal L Rev 811, <http://ssrn.com/abstract=904004> [hereinafter Hu and Black, 'Decoupling I (Southern Cal)']; Henry TC Hu and Bernard Black, 'Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms' (2006) 61 Bus Law 1011, <http://ssrn.com/abstract=887183> [hereinafter Hu and Black, 'Decoupling I (Business Lawyer)']; Henry TC Hu and Bernard Black, 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership' (2007) 13 J Corp Fin 343, <http://ssrn.com/abstract=874098> [hereinafter Hu and Black, 'Decoupling I (Finance)']. All three of these 'first generation' articles by the same authors focused on equity decoupling.

2 The 'second generation' research refined the initial analytical framework, including extending the framework to debt and hybrid decoupling, and ultimately started examining 'manufactured defaults' and other abuses in the credit default swap market. See, eg, Henry TC Hu and Jay L Westbrook, 'Abolition of the Corporate Duty to Creditors' (2007) 107 Colum L Rev 1321, 1329, 1401, <http://ssrn.com/abstract=977582>; Henry TC Hu and Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 156 U Pa L Rev 625, <http://ssrn.com/abstract=1030721> [hereinafter Hu and Black, 'Decoupling II (Penn)']; Henry TC Hu and Bernard Black, 'Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications' (2008) 14 Eur Fin Mgmt 663, <http://ssrn.com/abstract=1084075> (near-final version) [hereinafter Hu and Black, 'Decoupling II (EFM)']; Henry TC Hu, 'Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency' (2015) 70 Bus Law 347, <https://ssrn.com/abstract=2588052> (hereinafter Hu, 'Innovation and Governance'); Henry TC Hu, 'Corporate Distress, Credit Default Swaps, and Defaults: Information and Traditional, Contingent, and Empty Creditors' (2018) 12 Brook J Corp Fin & Com L 5, <https://ssrn.com/abstract=3302816> [hereinafter Hu, 'CDS Decoupling & Abuses'].

Exchange Act Section 13(d) variety. The analytical framework termed this use of such 'synthetic' equity holdings the 'hidden (morphable) ownership' strategy.

With respect to the central law-based mechanism for corporate governance—the shareholder vote—decoupling can, in an extreme case, result in shareholders having perverse incentives in tandem with the power to realize on those incentives. The extreme type of 'empty voter', what the framework termed an 'empty voter with negative economic ownership', would have incentives to use the voting power that it has as a shareholder not to see that the company do well and the share price increase, but to see that the company do badly and the share price drop.

With respect to debt governance, credit derivatives such as credit default swaps (CDSs) resulted in analogous substantive and disclosure problems. The extreme case of an 'empty creditor', what the framework termed an 'empty creditor with negative economic ownership' or an 'empty creditor with negative economic interest', would have the incentive to use the control rights the creditor has under the debt agreement not to ensure repayment, but to seek that the company default and fail. Even in such circumstances, where the creditor is thus 'net short', neither the borrower nor market participants generally may even be aware that this creditor has an extreme form of 'hidden non-interest' in the borrower.

These academic articles urged the SEC—and substantive-law centred authorities (such as Delaware) and private ordering—to play roles in addressing the dark side.

Early signs were encouraging. On 26 January 2007, a front-page *Wall Street Journal* story quoted SEC Chairman Christopher Cox as stating that empty voting 'is almost certainly going to force further regulatory response to ensure that investors' interests are protected' and that '[t]his is already a serious issue and it is showing all signs of growing'.[3] Market participants readily recognized the significance of empty voting and hidden (morphable) ownership, and the SEC reportedly began considering reforms.[4]

Despite these early signs, the SEC did not propose any material reforms directed at decoupling. The closest it came was a July 2010 SEC Concept Release that set out for the first time a detailed 'official' view of the decoupling phenomenon, utilizing the analytical framework and associated terminology.[5] And the House Financial Services Committee did raise questions on empty creditor issues in hearings that led to the Dodd–Frank Act.[6] But, on balance, the GFC, Dodd–Frank, and Dodd–Frank implementation drained the SEC of the necessary bandwidth to address decoupling. Speaking in 2014, after she returned to

3 Kara Scannell, 'How Borrowed Shares Swing Company Votes—SEC and Others Fear Hedge-Fund Strategy May Subvert Elections' *Wall Street Journal* (26 January 2007) A1 (New York).

4 See, eg, Ben White, 'Thesis on Hedge Fund Tactics Gives Investors a Shock—Professor's Warning on "empty voting" has had Big Impact in the U.S.' *Financial Times* (6 October 2006) 21 (London); Ben White, 'Concern in US over "empty voting"' *Financial Times* (6 October 2006) 21 (London).

5 See Concept Release on the US Proxy System, Exchange Act Release No 62495, at 137–50 (14 July 2010) (section titled '"Empty Voting" and Related "Decoupling" Issues'); Kara Scannell, 'SEC Delves into "Proxy Plumbing" – Biggest Review in 30 Years Puts Empty Voting, Adviser Conflicts, Other Issues Under the Microscope' *Wall Street Journal* (15 July 2010) C3 (New York). The author was the Director of the SEC's Division of Risk, Strategy, and Financial Innovation (now 'Division of Economic and Risk Analysis') at the time, and he and his staff were involved in this Concept Release.

6 *Reform of the Over-the-Counter Derivatives Market: Limiting Risk and Ensuring Fairness*, Hearing before the House Comm Fin Serv, 111th Cong–1st Sess, at 19–43, 147–56 (7 October 2009).

private life, former SEC Chairman Mary Schapiro stated that '[w]ith the 100 or so Dodd–Frank rules on our plate, we didn't have a chance to address this issue during my tenure'.[7]

Now, the SEC has moved. In late 2021 and early 2022, the SEC voted out proposals directed at decoupling, as well as other proposals that will have effects on decoupling.

This article is the first work to consider this spectrum of SEC proposals as a whole and does so using the perspective offered by the analytical framework. Beyond outlining some of the key aspects of the proposals, I suggest some significant changes and offer ideas for enhancing the cost–benefit analysis (CBA) essential to the rulemaking surviving likely DC Circuit court challenges. Finally, I situate the prospective SEC role with the roles that substantive law-centred authorities and private ordering have already begun to play, especially with respect to empty voting and empty crediting.

With respect to the hidden (morphable) ownership strategy, the SEC proposals would create a complex regulatory architecture consisting of two widely discordant disclosure regimes for synthetic equity holdings, a contraption worthy of Rube Goldberg. One disclosure regime is designed to address this decoupling strategy, cognizant of the need to strike the right balance as to diverse corporate governance-related goals. The other disclosure regime is not designed to address this decoupling strategy or corporate governance generally. Instead, it is directed at fraud and manipulation and promoting financial stability.

A fundamental problem arises from the conjunction of (a) the situs of the key technique for implementing the hidden (morphable) ownership strategy as between these two regimes; and (b) a silo mindset that pervaded the design of these regimes. The key implementation technique relies on the use of cash-settled equity swaps. The situs of disclosure requirements for cash-settled equity swaps is not, however, in the disclosure regime designed to address hidden (morphable) ownership but is instead in the one directed at fraud and manipulation and financial stability. But the features of this latter disclosure regime are wholly inappropriate to addressing the hidden (morphable) ownership phenomenon and undermine important corporate governance goals. Instead of using a holistic mindset, one that considered the overall impact of the bifurcated regulatory architecture for synthetic equity holdings, the SEC designed the features of this latter disclosure regime with a silo mindset, looking solely at that regime's narrow fraud and manipulation and financial stability goals.

The basic result of this situs/silo problem is that the overall regulatory architecture for synthetic equity subjugates the need to address hidden (morphable) ownership and undermines corporate governance. As a byproduct of the problem, the SEC's approach creates startling asymmetries in disclosure requirements as between direct holdings of stock and synthetic holdings as well as between different kinds of synthetic holdings.

I offer a partial, straightforward solution, one that in effect, does an end-run around the situs/silo problem. The result is a regulatory approach that would far better address the

7 Michael Siconolfi and Susan Pulliam, 'SEC is Urged to Shorten Window for Investor Tip-offs' *Wall Street Journal* (27 March 2014) (New York), <https://www.wsj.com/articles/SB10001424052702304688104579465661917560346>.

hidden (morphable) ownership phenomenon and associated corporate governance considerations. The solution would also reduce the regulatory asymmetries.

The article also outlines ways that the SEC can more firmly establish that there are reasons to believe hidden (morphable) ownership does occur and is not just a matter of conjecture. In the forthcoming court CBA-based challenges, this issue poses an existential threat to the SEC taking any action in this area. In addition to undertaking more factfinding on its own, the SEC has at least two additional avenues.

First, US-related court records and findings can yield seconded data. I illustrate with two such cases. Second, the actions of, and data-gathering methodologies used by regulators in foreign jurisdictions can be helpful. The SEC turns out to be anomalous. All 10 individual foreign jurisdictions examined—Australia, Canada, France, Germany, Hong Kong, Ireland, Italy, Netherlands, Switzerland, and the UK—have already modernized their blockholder disclosure provisions. A matrix showing the treatment of cash-settled equity swaps in these jurisdictions makes the contrast with the existing SEC regime manifest.

With respect to empty voting, the SEC's prospective role would primarily be to support efforts of substantive corporate law authorities and private ordering to address the phenomenon. Judges in Delaware and elsewhere are intervening directly with respect to the exercise of voting rights by empty voters, sometimes explicitly relying on the analytical framework. Private ordering is also occurring in a variety of forms. Certain SEC proposals, namely the ones directed at proxy voting, share lending, and short selling may have some limited impact on empty voting. Other SEC proposals, notably those requiring public disclosure of derivatives holdings, can help judges and private ordering identify the presence of empty voting.

With respect to empty crediting and hidden non-interest, the SEC is relying on the CDS-related aspects of a new, very burdensome Schedule 10B. The SEC expressly posits such Schedule 10B disclosure as its antidote to debt decoupling, especially of the empty crediting with negative economic interest variety. Ironically, its key operative mechanism fails to consider the fact that such decoupling depends on having *both* (a) possession of the CDS giving the holder possibly troublesome incentives and (b) possession of control rights flowing from debt agreements. By missing this existential link, Schedule 10B requires disclosure even when empty crediting of any sort is literally impossible. In addition, the key operative mechanism considers holdings of CDSs on a gross basis, not a net basis, and uses a one-size-fits-all absolute dollar threshold for disclosure. These features result in the imposition of burdensome disclosure requirements even when the holder has no or *de minimis* incentives that are troublesome.

The CDS-related aspects of Schedule 10B would thus have to be largely justified instead on the SEC's various non-decoupling-related goals. But even when considered solely from the perspective of these goals, the proposed Schedule 10B is vulnerable to court CBA-based challenges. There is a real risk that the overall Schedule 10B enterprise will not survive such challenges, something that the SEC itself appears to have implicitly recognized in writing.

The SEC needs a back-up plan, one that would at least address debt decoupling. I propose elements of such a plan. The plan is less burdensome and has disclosure requirements that can only be triggered if material debt decoupling is possible and where there may be significant incentives to engage in untoward behaviour. I situate this modified SEC approach in a world where private ordering—such as through 'net short' provisions in debt agreements—is becoming increasingly important. However, positive externalities and other factors result in private ordering being insufficient. The SEC has a vital role in promoting the extent and efficiency of private ordering and stepping in when private ordering is not possible.

The article is organized as follows.

Part I offers an overview of the analytical framework for decoupling and associated terminology.

Part II considers the hidden (morphable) ownership type of equity decoupling and the associated SEC proposals.

Parts II.A and II.B offer an overview and brief descriptions of the proposals. Part II.C shows two pathways for the SEC to better substantiate the need for intervention, one involving US court findings and records and the other involving the actions of foreign jurisdictions. Part II.D shows that the SEC's proposed approach subjugates the need to address hidden (morphable) ownership and associated corporate governance considerations. I offer a partial solution.

Part II centres on the revisions to Schedule 13D proposed in SEC Release 33-11030 voted out in February 2022 (the 'Beneficial Ownership Release') and the equity side of the new Schedule 10B proposed in SEC Release 34-93784 voted out in December 2021 (the 'Swaps Release').[8]

Part III considers empty voting on the equity decoupling side and empty crediting and hidden non-interest on the debt decoupling side. I also consider the current roles of private ordering and state substantive corporate law authorities and the prospective role of the SEC.

Part III.A offers an overview.

Part III.B focuses on empty voting and corporate governance. I briefly outline the SEC's proposed Releases relating to proxy voting, share lending and short selling which may have some limited effects.[9] Delaware has responded to empty voting in manifold ways. Private ordering is also making inroads. One SEC proposal for disclosure of certain derivatives

8 See Modernization of Beneficial Ownership Reporting, Securities Act Release No 11030, 87 Fed Reg 13,846 (10 March 2022) (hereinafter *Beneficial Ownership Release*); Prohibition Against Fraud, Manipulation, or Deception in connection With Security-Based Swaps: Prohibition Against Undue Influence Over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions, Exchange Act Release No 93784, 87 Fed Reg 6,652 (4 February 2022) (hereinafter *Swaps Release*).

9 See Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, Exchange Act Release No 93169, 86 Fed Reg 57,478 (15 October 2021) (hereinafter *Proxy Voting Release*); Reporting of Securities Loans, Exchange Act Release No 93613, 86 Fed Reg 69,802 (8 December 2021) (hereinafter *Share Lending Release*); Short Position and Short Activity Reporting by Institutional Investment Managers, Exchange Act Release No 94313, 87 Fed Reg 14,950 (hereinafter *Short Selling Release*).

holdings would enable the SEC to be of material help to the Delaware judiciary and those involved in private ordering by alerting them to the presence of empty voters.

Part III.C focuses on empty crediting, hidden non-interest, and debt governance. I show that while private ordering has made important strides in addressing debt decoupling, the SEC also has a vital role that it must begin playing. In this respect, I urge fundamental changes to the CDS-related disclosures of the proposed Schedule 10B.

I. Decoupling and debt and corporate governance

A. *Overview*

Ownership of equity typically conveys a package of economic rights, voting rights and other rights—and disclosure and other obligations.[10] A shareholder in a public corporation may be entitled, for instance, to dividends and a right to vote—and, if its holdings are large enough, be obligated to promptly disclose its stake. Similarly, a debt holder has economic rights given by contract (such as to principal and interest specified in the loan agreement or bond indenture), the control rights specified by contract (such as covenants and remedies on breach), and other legal rights.

These classic understandings of 'equity' and 'debt' assume that the elements of these packages of rights and obligations are generally 'bundled' together. With equity, the voting rights are usually linked to the shareholder's economic interest, as is the case with the familiar 'one share–one vote' pattern. With debt, the holder's contractual control rights are linked to the debt holder's economic rights to interest and principal.

In fact, however, through the use of derivatives, the share lending market, and other means, sophisticated debt and equity holders of a corporation can, if they wish, separate these elements—all without the consent and often without the knowledge of the corporation. The analytical framework coined the term 'decoupling' to refer to this separation.

A variety of rights can and have been decoupled from economic interest. In terms of equity decoupling, shareholder voting rights have been especially prominent in this respect.[11] The analytical framework uses the term 'voting ownership' to refer to the possession of the legal right to vote shares (including the power to instruct someone else how to vote) as well as informal rights to vote shares (including the 'informal' power to instruct someone else how to vote or to otherwise obtain formal voting rights). 'Economic ownership' refers to possession of the economic returns associated with shares. For simplicity, the framework generally refers to anyone with both 'voting ownership' and 'economic ownership' as having 'full ownership'.

10 This Part I overview is based in part on Hu and Black, 'Decoupling I (Southern Cal)' (n 1); Hu and Black, 'Decoupling II (Penn)' (n 2); Hu and Black, 'Decoupling II (EFM)' (n 2); Hu, 'Innovation and Governance (n 2); Hu, 'CDS Decoupling & Abuses' (n 2); Henry TC Hu, '"Empty Creditors" and the Crisis' *Wall Street Journal* (10 April 2009) A13 [hereinafter Hu, *Empty Creditors and GFC*]; Henry TC Hu, 'Reform the Credit Default Swap Market to Rein in Abuses' *Financial Times* (24 February 2019), <https://www.ft.com/content/1fcd2f34-2e14-11e9-80d2-7b637a9e1ba1> [hereinafter Hu, *Reform the CDS Market*].

11 See Hu and Black, 'Decoupling II (EFM)' (n 2) 666, 677–78; cf Hu and Black, 'Decoupling II (Penn)' (n 2) 721–28 (discussing decoupling of shareholder rights and obligations beyond voting and economic ownership rights and disclosure obligations).

The challenges that the decoupling of equity and debt present stem in part from failures to recognize this new reality. The longstanding legal and regulatory architecture, business and contracting practices, and economic theories relating to governance are generally based on the presumption of an immutable link between control rights and economic interest.

Decoupling occurs differently with respect to equity and debt. I start with an overview of equity decoupling and then turn to debt and hybrid decoupling.

B. *Equity decoupling: empty voters, empty voters with negative economic ownership, morphable ownership and hidden (morphable) ownership*

Certain equity decoupling concepts are especially relevant to governance: 'empty voting', 'morphable ownership' and 'hidden (morphable) ownership'. One category of empty voting poses special challenges: 'empty voting with negative economic ownership'.

Both empty voting and morphable ownership centre on the separation of voting rights and economic interest. 'Empty voting' involves persons obtaining voting rights greater than their economic interest. The analytical framework called this pattern 'empty voting' because the votes have been 'emptied' of a corresponding economic interest in the shares. 'Morphable ownership' is basically the converse: persons obtaining economic interest greater than their (formal) voting rights but effectively having the ability to 'morph' that economic-only stake to outright ownership of shares at any time.

Empty voting revolves around substantive voting rights, irrespective of context. Morphable ownership arises largely in the context of the market for corporate control: eg, the application of blockholder disclosure rules and the application of poison pills intended to protect incumbent management.

Empty voting can occur through a wide variety of means. For example, say a hedge fund has 1,000,000 shares in a typical one-share/one-vote corporation and thus has 1,000,000 votes. At the same time, the fund buys put options or a short equity swap position or sells short. The fund still has 1,000,000 votes, but because of coupling the shares with those put options, short equity swap positions or short selling, the fund may have the economic equivalent of, say, only 300,000 shares. This type of voter can be called an 'empty voter' since the votes have been emptied of a corresponding economic interest. The concept is a 'relative' one, not an absolute one.

Instead of relying on derivatives or on short selling, an empty voter may rely on other products and contractual arrangements. Under the normal stock lending arrangements, the borrower has no economic exposure to the company, but because the borrower is the legal owner of the shares, the borrower has the voting rights associated with the shares.[12]

From one perspective, empty voting is counter to the spirit of the voting structure established by charter at the typical corporation. The 'one-share/one-vote' pattern involves proportionality between economic rights and voting rights, and existing and potential

12 See Hu and Black, 'Decoupling I (Southern Cal)' (n 1) 831–32; Hu and Black, 'Decoupling II (Penn)' (n 2) 642–52, 688–92, 694–95, 706–7; Hu and Black, 'Decoupling II (EFM)' (n 2) 674–75.

shareholders buying shares in the company normally presume that such proportionality is applicable to everyone. Empty voting allows a shareholder to decide on its own how much voting power it chooses to have. Questions of fairness and legitimacy, as well as other concerns, arise.

Nevertheless, with one major exception, from a purely instrumental standpoint, whether empty voting, on balance, furthers or detracts from good corporate governance is unclear and highly contextual. One argument for empty voting is that it may help outsiders overcome the usual collective action problems in challenging incompetent or self-serving incumbent management.[13]

The major exception is when the empty voter has engaged in so much decoupling that it has negative economic ownership. What if the hedge fund who held 1,000,000 shares in our example had sold short 2,000,000 shares or bought a huge number of put options. This extreme type of shareholder would actually benefit if the share price decreased. This 'empty voter with negative economic ownership'—along with other kinds of 'empty voters with negative economic interest'[14]—would have the incentive to use its voting rights to cause the company's share price to fall, not to rise.

I have argued that corporate law should intervene directly and bar voting in the extreme case of negative economic ownership.[15] The basic underlying premise of state statutes requiring shareholders to elect directors and approve certain business combinations is that shareholders generally have an interest in increasing shareholder value, something that benefits all shareholders. Empty voters with negative economic ownership have the incentive to elect Inspector Clouseau to the board and to vote for shareholder wealth-destroying mergers. Such shareholders also have voting rights that they can deploy to realize their highly idiosyncratic goals. Perverse incentives in tandem with such control rights result in privately and socially destructive behaviour.

In Part III.B.2, I describe the *TELUS* case to illustrate the empty voter with negative economic ownership issue.

With 'morphable ownership', the decoupling is intended to try to avoid the effects of certain statutory mandates (eg, Section 13(d)) or company-based mandates (eg, poison pills) related to the market for corporate control. For instance, a strategy involving the converse of empty voting—achieving (formal) voting ownership lower than economic ownership while in fact being able to morph into full ownership at any time—may allow the avoidance of Section 13(d) blockholder disclosure rules. This use of decoupling does not seek to deviate from the normal allocation of substantive voting rights but instead tries to game shareholder disclosure obligations, which are often triggered in takeover battles. The

13 For the pluses and minuses of empty voting in general, see, eg, Hu and Black, 'Decoupling I (Southern Cal)' (n 1) 850–64; Hu and Black, 'Decoupling I (Finance)' (n 1) 353–59; Hu and Black, 'Decoupling II (Penn)' (n 2) 697–707; Hu and Black, 'Decoupling II (EFM)' (n 2) 667–72.

14 For the distinction between 'empty voters with negative economic ownership' and 'empty voters with negative economic interests', see Hu and Black, 'Decoupling I (Southern Cal)' (n 1) 831–32; Hu and Black, 'Decoupling II (Penn)' (n 2) 642–52, 688–92, 694–95, 706–7; Hu and Black, 'Decoupling II (EFM)' (n 2) 674–75.

15 Hu and Black, 'Decoupling II (Penn)' (n 2) 701.

analytical framework termed this use of decoupling as the 'hidden (morphable) ownership' strategy.

Companies often use the concept of morphable ownership in their poison pill arrangements. Poison pills are triggered by an outsider acquiring an ownership stake beyond a certain threshold. Unless the company's poison pill arrangements explicitly include morphable ownership stakes, the outsider may be able to avoid triggering the pill. This and other forms of private ordering to address equity decoupling are discussed in Part III.B.3.

I will focus largely on the use of morphable ownership to avoid Section 13(d) disclosure. The USA and many other countries require persons who acquire large positions in the shares of a corporation to promptly make public disclosure of their stakes. Such acquisitions often presage a takeover attempt. The disclosures alert both investors and incumbent management of the possibility of a change in control.

As will be discussed more fully in Part II.A, traditionally, these disclosure rules often depended on the possession of voting rights beyond specified thresholds. This led to a simple decoupling-based avoidance strategy. An investor can hold economic-only ownership through cash-settled equity swaps (also known as 'total return equity swaps').[16] This ownership is 'hidden' in that, arguably, it is not disclosable. However, this economic-only ownership is sometimes 'morphable'. That is, although the investor holds only these swaps, not shares, and thus has no formal voting rights, the investor may be able to acquire the voting rights when needed. For instance, this would be so if the investor, simultaneous with terminating the swaps and, if the swap dealer is willing, buying from the dealer the 'matched shares' the dealer held to hedge those equity swaps. Or perhaps that dealer will be willing to vote the way its customer directs. Either way, the investor has morphed from economic-only ownership to full ownership.

The *CSX* and *Rubicon* cases discussed in Part II.C.2 illustrate the application of Section 13(d) principles to this situation.

C. *Debt and hybrid decoupling: empty creditors, empty creditors with negative economic interest and hidden interest/non-interest*

For corporations that are in or near financial distress, decoupling associated with debt, not equity, raises the most significant issues. In the interests of brevity, this article's discussion of debt decoupling considers only the single-company borrowers, and only those borrowers that are not in bankruptcy.[17]

'Empty crediting' and 'hidden non-interest'/'hidden interest' issues are debt decoupling's analogues to equity decoupling's 'empty voting' and 'hidden (morphable) ownership' issues. The web of interactions of creditors and firms (or other debtors)—'debt governance'—is now perhaps less efficient and certainly more complex with the presence of more

16 In this article, I will generally use 'cash settled equity swaps' to also include 'contracts for differences' (CfDs), a derivative widely used in the UK.

17 For readers interested in the multi-borrower context (eg, securitizations) and the corporations in bankruptcy context, see, eg, Hu and Black, 'Decoupling II (EFM)' (n 2) 686–88, 690–93.

and often hidden parties (including contingent creditors such as CDS protection sellers) and unfamiliar incentive patterns.

Nevertheless, overall, debt decoupling is very likely both privately and socially valuable. Among other things, because of the availability of CDSs, creditors may make loans that they might not otherwise make because they know that they can later hedge some or all of the credit risk. Empty crediting in general, like empty voting in general, has both benefits and costs.

However, there is a clear instance where debt decoupling can be said to be privately and socially destructive: 'empty creditors with negative economic interest' or 'empty creditors with negative economic ownership'. These 'net short' creditors have an incentive structure quite different from that of a traditional creditor. This extreme category of empty creditor has an incentive to see the corporation file for bankruptcy (roughly analogous to incentives that an empty voter with negative economic ownership has to see the share price fall). For example, say a creditor extended a $10,000,000 loan to a company but bought CDS protection in the amount of $50,000,000. The creditor would actually benefit from its borrower filing for bankruptcy. That is, the payoff from the creditor's CDS position on the bankruptcy filing may well exceed any loss the creditor suffers on its loan position.

However, merely having the desire to see a company go into bankruptcy is, by itself, not troublesome from a private or social standpoint. It is the combination of such incentives with having the contractual rights given to the creditor in the loan agreement or bond indenture that causes debt decoupling and attendant concerns.

Subject to reputational and other concerns, this extreme category of empty creditors would have incentives to use its contractual control rights not to ensure that it is repaid, but instead to the extent legally and contractually permissible, to help grease the skids to bankruptcy. Traditional creditors often grant waivers for breaches to the loan agreement, agree to out-of-court restructurings, and otherwise work with a troubled borrower in circumstances where such actions and monitoring make sense for both the creditors and their borrowers. An empty creditor with negative economic interest would have far less incentive to engage in such actions or monitoring.

The Windstream situation to be described in Part III.C.1 is a possible illustration of this net short creditor problem.

Debt decoupling can be combined with equity decoupling, producing 'hybrid decoupling'. In the above empty crediting example, the creditor relied on CDSs referencing the company. The creditor can also hedge a variety of other ways. For instance, the creditor can hedge exposure to a company going bankrupt by buying put options on the company's shares. As for empty voting, the shareholder could buy CDS protection from a derivatives dealer. If a company does poorly, the likelihood of the company defaulting on its debt increases, and so the value of the CDSs will increase.

'Hidden non-interest' and 'hidden interest' issues arise, perhaps undermining the efficiency of debt governance. For instance, if a creditor has decoupled and the borrower (or the financial market generally) is unaware of this, that creditor has a 'hidden non-interest':

the creditor does not have the economic interest that the debtor and others think it has. Other parties that have taken the other side of decoupling transactions (ie, the protection sellers) may now have some of the original rights and obligations. If the debtor (or the financial market generally) is unaware of this, these other parties (that are also creditors, albeit contingent creditors) have 'hidden interests'.

II. Hidden (morphable) ownership: the SEC's proposed role

A. *Overview: legal archaeology and the SEC's proposed disclosure architecture*

The hidden (morphable) ownership strategy involves efforts to use cash-settled synthetic equity holdings to avoid reporting under large blockholder disclosure requirements in a change of control context.[18] In the USA, such requirements stem from Section 13(d) of the Securities Exchange Act of 1934, as implemented through rules adopted thereunder and Schedule 13D.

A smart Martian innocent of the ways of Washington would think that any SEC attempt to curb this Section 13(d) regime avoidance strategy would be to simply modify the Section 13(d) regime to directly comprehend cash-settled equity swaps and other cash-settled synthetic equity holdings. But the archaeology of the pertinent law, most notably an arcane provision tucked into the 2010 Dodd–Frank Act (Section 766), precluded this straightforward approach. The result is a byzantine regulatory architecture consisting of two wildly dissonant regulatory structures cobbled together as a byproduct of a game of statutory arbitrage.

One of the proposed regulatory structures is indeed focused on reforming how Section 13(d) treats direct and synthetic equity holdings, and this structure's features flow from the Section 13(d) corporate governance goals. The other proposed structure is instead predicated on Exchange Act Section 10B, and the structure's features flow from goals relating to fraud and manipulation and financial stability, especially the soundness of derivatives dealers. Two different structures with vastly different features and goals together house all cash-settled synthetic equity holdings. Ironically, due to the zoning restriction imposed by Dodd–Frank, the type of synthetic equity holding most important to the hidden (morphable) ownership strategy is housed in the structure that was categorically not designed to address the strategy.

That is, the proposed revision of Schedule 13D applies only when the synthetic equity is not in the form of cash-settled equity swaps—ie, when the strategy did not rely on the typical derivative that has historically been used in the strategy. This was set out in the February 2022 Beneficial Ownership Release.[19]

18 Although this article focuses on Schedule 13D and touches lightly on Schedule 13G, there are other shareholder ownership disclosure requirements as well. These include requirements relating to Form 13F reporting by institutional money managers, insider and 10% shareholder disclosure requirements flowing from Exchange Act Section 16, mutual fund/exchange-traded fund reporting requirements, and the Hart–Scott–Rodino Antitrust Improvements Act. See, eg, Hu and Black, 'Decoupling I (Southern Cal)' (n 1) 871–75; Hu and Black, 'Decoupling II (Penn)' (n 2) 725.

19 See Beneficial Ownership Release (n 8).

Disclosure of cash-settled equity swap positions would instead be addressed by a new Schedule 10B adopted under Section 10B added to the Exchange Act by the Dodd–Frank Act. This new disclosure system and proposed Schedule 10B are set out in the December 2021 Swaps Release.[20] The features of Schedule 10B were designed solely to promote Schedule 10B's fraud and manipulation and financial stability goals.

This bifurcated architecture helps explain some of the problems in the overall SEC efforts relating to hidden (morphable) ownership. In the balance of this Part II.A, I discuss the archaeology of the pertinent law and this bifurcated architecture. Part II.B describes the differences in the two regimes with respect to scope, disclosure thresholds and filing dates. Part II.C addresses the existential challenge to SEC undertaking any actions in this area: the challenge based on the claim that hidden (morphable) strategy is a non-problem. I show that beyond additional SEC fact-finding, there are at least two promising pathways for the SEC to address this challenge. In Part II.D, I show the situs/silo problem at the heart of my critique of the SEC's approach. The combination of the situs of the cash-settled equity swaps in the Schedule 10B regime and the silo mindset that governed the features of that regime result in an overall regulatory architecture that is largely unsuited to addressing the hidden (morphable) ownership phenomenon and associated corporate governance considerations. I offer an alternative.

Under Rule 13d-1 adopted under Section 13(d), any person who 'directly or indirectly' acquires 'beneficial ownership' of more than 5 per cent of a public company's shares must file a Schedule 13D with the SEC within 10 days after crossing the 5 per cent threshold.[21] Certain types of investors who invest 'passively' (in the ordinary course of business and without intent to influence control) can instead file a less burdensome Schedule 13G (generally on February 15 of each year, reporting year-end positions).[22] Schedules 13D and 13G, both of which are publicly available, must show the number and percentage of shares beneficially owned, and any purchases or sales within the past 60 days. Item 6 of Schedule 13D, which has no counterpart in Schedule 13G, also requires disclosure of any 'contracts, arrangements, understandings or relationships (legal or otherwise)' relating to any securities of the issuer.

Rule 13d-3 sets out two independent ways a person would be deemed a 'beneficial owner'. Rule 13d-3(a) sets out the core definition, one focused on the possession of voting or investment power. It provides that a 'beneficial owner' is 'any person' who 'directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise' holds voting or investment power in the security.[23] Rule 13d-3(b), in an effort to discourage gaming, provides that any person who uses any 'contract, arrangement, or device' to evade the reporting requirements is also deemed to be a beneficial owner.[24]

20 See Swaps Release (n 8).

21 See Exchange Act Rule 13d-1, Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1(a), (i) (2022).

22 See Exchange Act Rule 13d-1(b), 17 C.F.R. § 240.13d-1(b) (2022). When ownership first exceeds 10%, Schedule 13G must be filed by the tenth day of the next month. Ibid.

23 Exchange Act Rule 13d-3(a), 17 C.F.R. § 240.13d-3(a) (2022).

24 Exchange Act Rule 13d-3(b), 17 C.F.R. § 240.13-d-3(b) (2022).

An entity seeking to rely on the hidden (morphable) ownership strategy would need to avoid both the Rule 13d-3(a) core definition and the Rule 13d-3(b) anti-gaming definition. The entity may try to avoid the Rule 13d-3(a) core definition by holding cash-settled equity swaps. Holding such swaps does not give it any formal voting rights. As a technical matter, those swaps merely give it 'economic ownership' in the referenced shares. The entity may try to avoid the Rule 13d-3(b) anti-gaming definition by, for example, arguing that the entity did not have effective access to the matched shares (or the associated voting rights) that its derivatives dealers held to hedge the dealer's exposure on the swaps.

On 11 June 2008, the district court in the Southern District of New York decided the first (and still the only) litigated case as to the status of hidden (morphable) ownership strategy. The court in *CSX Corp v Children's Investment Fund Management (UK) LLP*[25] was faced with two hedge funds allegedly using the strategy to avoid Section 13(d) disclosure of their large synthetic stakes in CSX Corporation. In an opinion exhaustively discussing the details of the funds' strategy and relying in part on the decoupling analytical framework, the court found the funds violated Section 13(d). However, some 3 years later, a divided panel of the Second Circuit finally rendered its opinion but declined to reach the hidden (morphable) ownership issue at the heart of the case and remanded on other grounds.[26] Part II.C.2 discusses *CSX* in more detail.

In 2010, the legal uncertainties associated with this strategy were eliminated by Section 766 of Dodd–Frank—at least if the strategy relies on the use of cash-settled equity swaps. Section 766 amended Section 13 to provide that with respect to 'security-based swaps' (as defined in Exchange Act Section 3(a)(68))—a category that includes cash-settled equity swaps—persons will be deemed to have acquired beneficial ownership 'only if' the SEC determines by rule 'after consultation' with the [bank] prudential regulators and the Secretary of the Treasury that: (a) the swap 'provides incidents of ownership comparable to direct ownership of the equity security'; and (b) the determination is necessary to achieve the purposes of Section 13.[27]

This amendment, especially the 'incidents comparable to direct ownership' requirement, thus makes it difficult, if not impossible, for the SEC to revise Schedule 13D to cover the typical way hidden (morphable) ownership strategy occurs. Holders of cash-settled equity swaps have only economic ownership in the shares and, unlike direct owners, do not have formal voting rights.

The SEC's proposed change in the Rule 13d-3 definition to deem certain holders of cash-settled 'derivative securities' as beneficial holders recognized this constraint. For this purpose, 'derivative securities' uses the broad definition used in Exchange Act Section 16, except that, with respect to Rule 13d-3, it does not include security-based swaps.[28]

25 562 F Supp 2d 5121 (SDNY 2008). The author was engaged in this matter by Cravath, Swaine & Moore, counsel for CSX Corporation, to, among other things, offer views to the SEC on what advice the SEC should give to the court.

26 See *CSX Corp v Children's Inv Fund Mgmt LLP*, 654 F3d 276 (2d Cir 2011).

27 Exchange Act § 10(o), 15 USC § 78m(o).

28 Beneficial Ownership Release (n 8) 13,862, 13,864 n. 110.

The SEC took the position that Section 766 thus did not prohibit such a step.[29] Therefore, the proposed Schedule 13D covers the likely unusual situation of hidden (morphable) ownership strategies relying on derivative securities other than cash-settled equity swaps.

The likely more typical situation, where cash-settled equity swaps are used, would instead be covered in certain situations by the proposed Schedule 10B. Section 763(h) of Dodd–Frank, codified as Section 10B of the Exchange Act, gave the SEC authority to establish position limits for security-based swaps and rulemaking authority to require reporting of large security-based swap positions.[30]

Any person, regardless of whether that person is registered with the SEC in any way, who is directly or indirectly the owner or seller of a 'security-based swap position' that exceeds a specific quantitative threshold would be required to publicly disclose this on Schedule 10B. For the purposes of Schedule 10B, a 'security-based swap position' refers to all security-based swaps based on, as an example, a single security or loan, or a narrow-based security index, or any interest therein or based on the value thereof.[31] This clearly captures, among other products, both cash-settled equity swaps and CDSs. For this Part II on hidden (morphable) ownership, the equity swaps aspects of Schedule 10B is relevant. For the Part III discussion on empty crediting and hidden non-interest, the CDS aspects matter.

B. *The SEC's proposed bifurcated architecture: the revised Schedule 13d regime and the new Schedule 10B Regime*

Both the revised Schedule 13D and the new Schedule 10B would move towards disclosures undermining the hidden (morphable) strategy. Generally speaking, the former focuses on cash-settled derivative securities other than security-based swaps while the latter focuses on holdings of cash-settled equity swaps and other security-based swaps.

But differences extend beyond this, including differences as to scope, disclosure thresholds and filing dates.

1. Scope

Proposed Schedule 13D. The changes to Schedule 13D would extend coverage to cash-settled derivative securities other than security-based swaps. Closer examination suggests that, in some ways, the coverage is more limited than this but, in one way, is broader.

It is more limited than the principle would suggest in two ways, both of which relate to the purpose of the holding.

First, Schedule 13G can be filed instead of Schedule 13D if the person acquired the holdings 'in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer'.[32] The differences in filing deadlines

29 Ibid.

30 Swaps Release (n 8) 6,654, 6,657; 15 USC § 78j-2(d).

31 Swaps Release (n 8) 6,704 (proposed Rule 10B-1(b) (2)).

32 17 C.F.R. § 140.13d-1(b)(i).

(as well as the more abbreviated disclosures) make the information in Schedule 13G less useful to investors.

These differences may help explain why Elon Musk filed a Schedule 13G rather than a Schedule 13D on 4 April 2022, to disclose his acquisition of 9.2 per cent of the common stock of Twitter.[33] This raised eyebrows, including at the SEC. In a letter to Musk dated the same day, the SEC asked for an explanation of how Schedule 13G could be filed when, with limited exceptions, Schedule 13D must be filed if that person has acquired the securities with any purpose, or with the effect, of changing of influencing the control of the issuer.[34]

Second, proposed Rule 13d-3(e) does not deem all holders of a cash-settled derivative security (other than security-based swaps) to be beneficial owners.[35] Instead, it is only those persons who hold the derivative security:

> with the purpose or effect of changing or influencing the control of the issuer of such class of equity securities, or in connection with or as a participant in any transaction having such purpose or effect.[36]

The SEC is showing some signs that it intends to construe the 'purpose or effect' clause broadly for the purpose of Rule 13d-3(e). If this proves to be the case, the clause would have limited real-world significance.[37] The SEC did not appear to mean for the clause to be confined to the holder's pursuit of a hidden (morphable) ownership strategy. For instance, the SEC referred to how the matched shares that would arise from the derivative contracts could affect the universe of voting shares and thus the balance of voting power. The SEC noted that 'significant economic interest' confers credibility on an activist with other shareholders and appeared to suggest that this alone would suffice.

The ultimate status of this 'purpose or effect' clause is far from clear. There are signs that SEC may modify or abandon the proposed 'purpose or effect' requirement. It has asked for comments indicating some discomfort with what it proposed in this respect.[38]

It should be emphasized that, perhaps surprisingly, the proposed Schedule 13D sometimes unquestionably does capture cash-settled equity swap positions, notwithstanding Dodd–Frank Section 766. Item 6 of the current Schedule 13D requires beneficial owners to '[d]escribe any contracts, arrangements, understandings or relationships' and includes a non-exclusive list of examples that does not expressly include cash-settled derivative securities. The Swaps Release proposes amending Item 6 to clarify that a person is required to disclose interest in all derivative securities that use the issuer's equity security as a reference security, including cash-settled security-based swaps and other derivatives which are settled exclusively in cash.[39]

33 See Elon Musk, Schedule 13G (4 April 2022).

34 Letter from Nicholas P Panos, Senior Special Couns, Off of Mergers and Acquisitions, SEC, to Elon Musk (4 April 2022). The SEC also asked for an explanation why Schedule 13G was not filed within the required 10 days from the date of acquisition (14 March 2022).

35 Beneficial Ownership Release (n 8) 13,861–62.

36 Ibid 13,897.

37 Ibid 13,887.

38 Ibid 13,864 (request for comments 42–44).

39 Ibid 13,874.

Proposed Schedule 10B. Schedule 13D is not required to be filed outside of the change in control context and when the 'purpose or effect' requirement is not met. The new Schedule 10B does not impose either requirement. Mere possession of the requisite security-based swaps in the requisite amount is sufficient.[40]

2. Disclosure threshold

Proposed Schedule 13D. From a literal standpoint, the proposed Schedule 13D continues to use the 5 per cent threshold (calculated on a delta-adjusted basis). But one major substantive change likely would have the effect of lowering the threshold in many situations.

The effective lowering of the 5 per cent threshold stems from the SEC proposing a new, highly expansive definition of 'group'. Section 13(d) requires disclosure by any single 'person' with beneficial ownership of more than 5 per cent of a covered class of equity securities. When two or more persons 'act as' a 'group' for the purpose of acquiring, holding or disposing of the securities, such group will be deemed a 'person', and a 'group' is deemed to beneficially own all the securities owned by the members.[41]

In determining whether two or more persons act as a group, a number of courts (including the district court in the *CSX* case) held that a group can be formed only if an agreement exists among the members.[42] Consistent with these precedents, Rule 13d-5(b)(1)'s statement that '[w]hen two or more persons *agree to act together*' for one of four purposes, the group formed as a result is deemed to have acquired beneficial ownership of the securities held by all the members.

The SEC proposed a much more expansive notion of group, though characterizing the move as an effort to 'clarify and amplify' the operation of Scheduled 13D.[43] The SEC proposed to eliminate the requirement that there be an implied or express agreement. Instead, concerted actions by two or more persons would be sufficient.[44] Rule 13d-5(b)(1) would be redesignated as Rule 13d-5(b)(1)(i) and revised to remove the reference to an agreement between two or more persons and instead indicate that when two or more persons act as a group under Section 13(d)(3), the group will be deemed to have acquired beneficial ownership of all of the equity securities.

Proposed Schedule 10B. The threshold for a filing obligation as to proposed Schedule 10B depends on the type of security-based swap positions. Separate thresholds are set for: (a) positions that are CDSs; (b) positions on debt securities that are not CDSs; and (c) positions based on equity securities.[45]

From the standpoint of hidden (morphable) ownership, what matters is the threshold at (c), equity derivatives, the category applicable to cash-settled equity swaps. The overall

40 See Swaps Release (n 8) 6,657, 6,671–72.
41 See Exchange Act Section 13(d)(3) and 17 C.F.R. § 13d-5(b)(1).
42 Beneficial Ownership Release (n 8) 13,866–67.
43 Ibid 13,846.
44 Ibid 13,868–69.
45 Swaps Release (n 8) 6,669.

picture is that the threshold for synthetic equity is far lower than: (a) the 5 per cent direct holdings of shares trigger in the existing Schedule 13D; and (b) the 5 per cent direct and synthetic holdings trigger in the proposed Schedule 13D.

Specifically, the threshold for Schedule 10B for the pertinent synthetic equity holdings is the *lesser* of two different thresholds, one based on the notional amount of the position and one based on the percentage of outstanding shares attributable to the position:[46]

> 'with respect to the notional amount', a 'security-based swap position' that meets or exceeds $300 million, calculated on a gross basis (ie, including both long and short positions); however, if that position exceeds $150,000,000, the $300,000,000 calculation would also include the value of all of the underlying equity securities and any delta-adjusted notional amount of any derivative instrument based on the same class of equity securities.
>
> 'with respect to the percentage threshold', a 'security-based swap equivalent position' that represents more than 5 per cent of a class of equity securities (including underlying equity securities as well as the number of shares attributable to certain other derivatives, if the security-based swap equivalent position exceeds 2.5 per cent).

For the usual large public corporation, this threshold for cash-settled equity swap positions would constitute a drastic departure from the 5 per cent threshold for both the current Schedule 13D for direct stock holdings and the proposed Schedule 13D threshold for the derivatives positions it covers. The pertinent Schedule 10B threshold for a large public corporation would be the one based on the $300,000,000 notional amount. As of 31 August 2022, the median market capitalization of stocks in the S&P 500 was around $29 billion dollars.[47] A cash-settled equity swap in the amount of $300,000,000 corresponds to economic ownership of a mere 1 per cent of an issuer with that capitalization.

3. Filing date

Proposed Schedule 13D. The SEC is proposing a significant tightening of the filing deadline. The current initial filing deadline is 10 days after acquisition of more than 5 per cent.[48] The proposed change is to five days after acquisition.[49]

Proposed Schedule 10B. The filing deadlines that would be applicable to cash-settled equity swaps under the proposed Schedule 10B would be much tighter than both the existing Schedule 13D deadlines for direct share holdings and the proposed Schedule 13D deadlines for the derivatives that Schedule 13D would cover. In terms of the initial filing, Schedule 10Bs are required to be filed 'promptly', but in no event later than the end of the business day following the day of execution of the pertinent cash-settled equity swap.[50]

46 Ibid 6,671–72.

47 See *S&P 500 (USD) Factsheet*, S&P Global (31 August 2022), <https://www.spglobal.com/spdji/en/index-family/equity/us-equity/us-market-cap/#overview>.

48 Exchange Act Rule 13d-1(a), 17 C.F.R. § 240.13d-1(a).

49 Beneficial Ownership Release (n 8) 13,847.

50 Swaps Release (n 8) 6,668.

C. Towards a firmer foundation for SEC intervention

1. Overview

A central, existential argument against SEC intervention with respect to hidden (morphable) ownership must be addressed. Broadly speaking, the argument is that the hidden (morphable) ownership problem does not exist. Hedge fund manager Paul Singer's Elliott Management refers to the belief that 'derivatives may be used improperly to pressure counterparties to make decisions regarding the voting and disposition of reference securities' as 'unsubstantiated', that the SEC has provided 'no evidence to establish that this is an actual problem in the marketplace', and that it was not consistent with Elliott's 'experience or understanding of how the marketplace works'.[51]

The SEC is fully cognizant of the need for information. In its Beneficial Ownership Release, the SEC asked for comment on a series of questions centring on whether 'a cash-settled derivative [can] be used to influence or change the control of an issuer'.[52]

I agree that the SEC must establish a better foundation for the 'base case' for SEC action: that there are reasons to believe a hidden (morphable) ownership problem can sometimes arise from synthetic holdings. Responses to the SEC's request for comment on this matter would yield helpful data relating to US entities and current US marketplace conventions and practices.

But the SEC can go beyond factfinding. First, I show the potential usefulness of examining US-related court findings and records. I discuss two court cases to illustrate. Second, the SEC should determine why many comparable foreign jurisdictions—indeed, all of the ones that I looked at—have already acted in formal ways to address hidden (morphable) ownership. Moreover, the methods used overseas to engage in systematic data gathering, including review of the impact of disclosure modernization are worth examining.

2. Litigation involving US entities or US courts

Rubicon. Perry Corporation, a US hedge fund, was a pioneer with respect to equity decoupling. While it is perhaps best known for its attempt to engage in empty voting with a negative economic interest, it was also an early user of the hidden (morphable) ownership strategy.[53]

In early 2001, Perry was a major holder of Rubicon, Ltd, a publicly held New Zealand corporation. New Zealand had rules requiring disclosure of 5 per cent ownership stakes similar to rules adopted under Section 13(d). In June 2001, Perry gave notice that it had ceased to be a 5 per cent holder. A year later, to everyone's surprise, Perry disclosed that it held 16 per cent of Rubicon, having bought 31 million shares from Deutsche Bank and UBS Warburg just in time to vote at Rubicon's 2002 annual general meeting.

51 Elliott Investment Management LP, Comment Letter on Modernization of Beneficial Ownership Reporting 24 (11 April 2022).

52 Beneficial Ownership Release (n 8) 13,864 (request for comment 44).

53 *Ithaca (Custodians) Ltd v Perry Corp*, [2003] 2 N.Z.L.R. 216 (H.C.), *rev'd.* [2004] 1 N.Z.LR.731 (C.A.); [2004 2 N.Z.L.R. 182 (C.A.) (refusing conditional leave to appeal). This case is discussed in more detail in Hu and Black, 'Decoupling I (Southern Cal)' (n 1) 836–38.

What happened during the period when Perry apparently was not a substantial holder of Rubicon shares? In May 2001, Perry shed its voting rights, but not its economic interest. It sold 31 million shares to two derivatives dealers and simultaneously took the long side of cash-settled equity swaps for 31 million shares. Perry's 16 per cent economic ownership did not change, but it ceased reporting because, it claimed, the equity swaps fell outside the New Zealand disclosure rules. When Perry needed the formal voting rights, it terminated the swaps and bought the shares back from the dealers.

How did Perry know that it could 'morph' from the (nominal) economic-only ownership to outright ownership of the shares? The dealers needed to hedge their exposure from extending the swaps, and Perry could expect them to do so by holding the shares they had bought from Perry. Another means of hedging was unlikely, given the thin market in Rubicon shares. Perry could also expect the banks to be willing to sell the shares when Perry chose to unwind the swaps. The New Zealand Court of Appeal, which ruled in Perry's favour, found that:

> [I]t was almost certain that the shares would be sold to Perry Corporation upon the termination of the swaps if Perry Corporation wished to buy, provided the counterparties held the shares (... [which] was highly likely). We consider that this market reality would have been obvious to any reasonably informed market participant. Mr. Rosen, head trader at Perry Corporation, said in evidence that he had always thought it likely that the shares would be held by the counterparties as a hedge. He also said he had thought that, if he wanted to terminate the swaps and purchase the shares, it would be commercially sound for the ... counterparties to sell him those shares.[54]

CSX. As discussed, *CSX* is the only fully-litigated case in the USA with respect to an attempt to use the hidden (morphable) ownership strategy. The district court opinion found the hedge fund to be a 'beneficial owner' for the purposes of Section 13(d), doing so on the Rule 13d-3(b) anti-evasion leg of the definition. It found that the fund had used the swaps 'with the purpose and effect of the vesting of beneficial ownership' as part of a plan or scheme to evade the reporting requirements of Section 13(d).[55]

In a highly detailed opinion, the court found that the derivatives dealers for the Children's Investment Fund Management (TCI) hedged its exposure to CSX's share price 'on virtually a share-for-share basis and in each case the day or the day following the commencement of each swap'[56] and that the fund effectively would be able to acquire those shares at any time. The court found:

> On this record, TCI manifestly had the economic ability to cause its short counterparties to buy and sell the CSX shares. The very nature of the [total return swap] transactions, as a practical matter, required the counterparties to hedge their short exposures. And while there theoretically are means of hedging that do not require the purchase of physical shares, in the situation before the Court it is perfectly clear that the purchase of physical shares was the only practical alternative .... And once the counterparties bought the shares, TCI had the practical ability to cause them to sell

54 Ithaca (Custodians) Ltd, 1 N.Z.LR. 731, ¶ 66.
55 *CSX* (n 25) 548.
56 Ibid 541.

> simply by unwinding the swap transactions. Certainly the banks had no intention of allowing their swap desks to hold the unhedged long positions that would have resulted from the unwinding of the swaps.[57]

Moreover, the court found that there nevertheless was 'reason to believe' that the hedge fund 'was in a position to influence the counterparties, especially Deutsche Bank, with respect to the exercise of their voting rights'.[58] For instance, the court found that the hedge fund's managing partner moved swaps referencing 28 million shares to Deutsche Bank 'substantially out of [his] belief that he could influence the voting of the shares it held to hedge TCI's swaps'.[59]

Thus, in the terminology of the analytical framework, there were reasons to believe that the hedge fund could 'morph' its economic ownership in CSX shares to 'full ownership' at any time, either by gaining access to the matched shares or influencing how its derivatives dealers voted the matching shares they held. The district court opinion used the analytical framework for decoupling extensively.[60]

3. Foreign regulators: Australia, Canada, France, Germany, Hong Kong, Ireland, Italy, Netherlands, Switzerland and the UK

The SEC is anomalous in not having extended its blockholder disclosure rules to cover cash-settled equity swaps. The matrix below sets out how each of the individual jurisdictions examined has already done so: Australia, Canada, France, Germany, Hong Kong, Ireland, Italy, the Netherlands, and the UK. The matrix also includes rows for the current US regime and the proposed bifurcated US regime: current Schedule 13D, proposed Schedule 13D, and proposed Schedule 10B. Following the matrix are brief narrative discussions of the requirements in these individual jurisdictions, as well as a discussion of the European Union's adoption of Transparency Directive II.

All of the individual jurisdictions except Canada essentially treat such synthetic ownership as counting towards the disclosure threshold as if they were direct holdings.[61] Canada would include such synthetic holdings if the investor 'has the ability, formally or informally, to obtain the voting or equity securities or to direct the voting of voting securities held by any counterparties to the transaction'—ie, the apparent situation in *Rubicon* and *CSX*.

This alone provides grounds to believe that hidden (morphable) ownership can occur, at least in those foreign jurisdictions. Many of these European jurisdictions took these initiatives in response to cases similar to *Rubicon* and *CSX* that occurred in Europe.[62] For example, in 2008, the Schaeffler Group launched a takeover bid for Continental AG, a

57 Ibid 546.

58 Ibid 546.

59 Ibid 543–44.

60 See ibid 522, 542, 547, 573.

61 As discussed below, while Italy has a lower disclosure threshold that applies only to 'actual holdings' (ie, voting rights and voting shares), its disclosure regime for aggregate holdings (ie, actual holdings and equity investments in financial instruments) treat synthetic ownership and direct ownership in an equivalent way.

62 *Commission Staff Working Document on the Review of the Operation of Directive 2004/109/EC: Emerging Issues*, at 3, SEC (2009) 611 (27 May 2010), <https://op.europa.eu/en/publication-detail/-/publication/f61654b8-250f-4e3a-8ea7-c63877d17c37/lan

publicly traded company in Germany.[63] While Schaeffler held less than 3 per cent of the shares of Continental, Schaeffler had amassed an effective 36 per cent stake in Continental, including 28 per cent through cash-settled equity swaps.[64] Schaeffler never disclosed these positions, and BaFin, the German regulator, determined that Schaeffler's non-disclosure did not violate the laws in place at the time.[65]

In response to Continental and similar cases in Europe, a number of EU member jurisdictions initiated efforts to include cash-settled equity derivatives under their respective blockholder disclosure regimes.[66] At the EU level, the European Commission released a report identifying several shortcomings of its 2004 Transparency Directive,[67] including the finding that the 'lack of disclosure regarding cash-settled derivatives has led to [an] increased problem of 'hidden ownership'.[68] The report served as an impetus for amending the Transparency Directive to require member states to extend their blockholder disclosure regimes to holdings of cash-settled derivatives, including swaps and contracts for differences.[69]

Thus, many foreign regulatory authorities have identified the hidden (morphable) ownership strategy as a real issue and have sought to address it. The methodologies they relied on and any evaluations they did on the viability of the modernization efforts could prove instructive to the SEC as well.

For example, in considering whether to amend the Transparency Directive to cover cash-settled derivatives, the European Commission engaged outside consultants to survey

guage-en> (discussing cases in Europe involving cash-settled derivatives and hidden ownership and the regulatory response among EU Member States).

63 Comm Eur Sec Reguls, Consultation Paper: Proposal to Extend Major Shareholding Notifications to Instruments of Similar Economic Effect to Holding Shares and Entitlements to Acquire Shares 7 (2010) (hereinafter CESR Consultation Paper), <https://www.esma.europa.eu/sites/default/files/library/2015/11/09_1215b.pdf>.

64 Eur Sec Mkts Auth, Consultation Paper on Draft Regulatory Technical Standards on Major Shareholdings and Indicative List of Financial Instruments Subject to Notification Requirements Under the Revised Transparency Direct 7 (2014) (hereinafter ESMA Consultation Paper), <https://www.esma.europa.eu/document/draft-regulatory-technical-standards-major-shareholdings-and-indicative-list-financial>.

65 CESR Consultation Paper (n 63) 7.

66 ESMA Consultation Paper (n 64) 7.

67 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC.

68 *Report from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions: Operation of 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*, at 4–5, COM (2010) 243 final (27 May 2010). For a more detailed discussion of the Commission's findings regarding disclosures of holdings of cash-settled derivatives, see Annex 9 of the Accompanying Document to the Report from the Commission, <https://op.europa.eu/en/publication-detail/-/publication/f61654b8-250f-4e3a-8ea7-c63877d17c37/language-en>.

69 *Commission Proposal for a Directive of the European Parliament and of the Council Amending 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 and Commission Directive 2007/14/EC*, at 5, 19, COM (2011) 683 final (25 October 2011) (proposing these amendments to the Transparency Directive); Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the Harmonization of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market, Directive 2003/71/EC of the European Parliament and of the Council on the Prospectus to Be Published When Securities are Offered to the Public or Admitted to Trading and Commission Directive 2007/14/EC Laying Down Detailed Rules for the Implementation of Certain Provisions of Directive 2004/109/EC Text with EEA Relevance.

stakeholder opinions.[70] In response to the question of whether cash-settled equity swaps should be included in the calculation of disclosure thresholds, nearly 90 per cent of the stakeholders who expressed an opinion supported the proposal.[71] In deciding to propose the extension of blockholder disclosure regimes to cover cash-settled equity swaps and contracts for differences in the EU, the European Commission not only looked at several cases of hidden ownership but also considered academic research on decoupling.[72] Additionally, the European Commission surveyed the actions that had already been taken in jurisdictions across Europe, as well as in Hong Kong and Australia, to address hidden ownership.[73]

UK regulatory authorities have been systematic in their data-gathering and evaluation of the impact of the extension of disclosure to cash-settled equity derivatives. In 2005, the UK Takeover Panel decided to require disclosure of long and short economic ownership of 1 per cent or more in a target company during the pendency of a takeover bid.[74] The Panel sought to determine the impact of this change in 2007. It invited comments and conducted a survey on the new regime through an informal consultation. Comments were invited from 113 entities, including trade bodies, hedge funds, companies which had received takeover offers, money managers and other capital market participants.[75] In all, 89 respondents commented on the new dealing disclosure rules—with 90 per cent of the respondents to the survey being in favour of the new regime.[76] The Panel also found that after it changed its disclosure rules, the number of pertinent ownership disclosures increased by about 19 per cent over the period 7 November 2005 to 31 May 2007.

The Financial Services Authority said that it would consider the outcome of the Takeover Panel review in its 2006 review of the implementation of the EU's Transparency Directive.[77] It did so in its November 2007 report on the disclosure of holdings of contract

70 See generally Mazars, Transparency Directive Assessment Report (2009), <https://ec.europa.eu/info/sites/default/files/report-application-26012010_en.pdf>; see also *Commission Staff Working Document on the Review of the Operation of Directive 2004/109/EC: Emerging Issues*, at 3, SEC (2009) 611 (27 May 2010), <https://op.europa.eu/en/publication-detail/-/publication/f61654b8-250f-4e3a-8ea7-c63877d17c37/language-en> (discussing the Mazars survey).

71 Mazars (n 70) 132–33.

72 *Report from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions: Operation of 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*, at 4–5, COM (2010) 243 final (27 May 2010); *Commission Staff Working Document on the Review of the Operation of Directive 2004/109/EC: Emerging Issues*, at 71–72, SEC (2009) 611 (27 May 2010), <https://op.europa.eu/en/publication-detail/-/publication/f61654b8-250f-4e3a-8ea7-c63877d17c37/language-en> (discussing cases of hidden ownership in Europe); *Report from the Commission: Commission Staff Working Paper Impact Assessment*, at 19–20, SEC (2011) 1279 final (2 March 2012), <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX : 52011SC1279&from=EN> (citing decoupling research).

73 Ibid 94–96.

74 See Hu and Black, 'Decoupling II (Penn)' (n 2) 686.

75 Takeover Panel Code Comm (UK), Derivatives and Options Regime: 2007 Review (29 June 2007), <https://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/2007-15.pdf>.

76 Ibid.

77 Financial Services Authority, Implementation of the Transparency Directive: Investment Entities Listing Review 50 (March 2006), <https://webarchive.nationalarchives.gov.uk/ukgwa/20120302232208/http://www.fsa.gov.uk/pubs/cp/cp06_04.pdf> ('In deciding whether and how to take this issue forward we will also consider the outcome of the review by the Takeover Panel in June 2007 of, amongst other things, the new rules of the Takeover Code relating to the disclosure of dealings in derivatives and options.')

for differences (CfD), a type of cash-settled derivative.[78] In the report, the FSA also reviewed literature on the impact of disclosure on price efficiency in securities markets, empirically studied the impact of major shareholder notification on price formation, contracted with PwC to review the practices of the most active CfD writers, and studied the level and patterns of CfD trading inside and outside of offer periods.[79]

Current market practices with respect to synthetic holdings of US stocks may differ from synthetic holdings of overseas stocks that had spurred the foreign authorities. The SEC needs to find out and consider as well how market practices, if unconstrained, can change.

The evidence that the SEC can glean from those regulators is not necessarily jurisdiction specific. If, for instance, a US hedge fund finds that its primary derivatives dealer in the US is unwilling to accommodate its hidden (morphable) ownership strategy with respect to shares of a US company, might not the hedge fund try to find succour with a derivatives dealer that operates overseas? The nature of the pertinent derivatives dealers, hedge funds and other activists, and strategies is quite international. Deutsche Bank, a German bank, appears in both the New Zealand *Rubicon* case and the US *CSX* case. Merrill Lynch served as the derivatives dealer for Schaeffler in its holdings of cash-settled equity swaps referencing the shares of Continental.[80] Many key hedge funds operate internationally and use the same cash-settled swap-based hidden (morphable) ownership strategy: note how US-based Perry appears in the New Zealand *Rubicon* case and UK-based TCI appears in the US *CSX* case.

European Union

In 2013, the EU adopted Directive 2013/50/EU,[81] which amended Directive 2004/109/EC (the 'Transparency Directive')[82] and established cross-EU baselines for disclosure of major holdings of cash-settled derivatives.[83] The amended Transparency Directive requires the

78 Financial Services Authority, *Disclosure of Contracts for Difference*: *Consultation and draft Handbook text* (November 2007), <http://www.efmlg.org/Docs/Meeting%2026/Item%206a_FSA_disclosure%20of%20contracts%20for%20difference_cp07.20_Nov2007.pdf>.

79 Ibid.

80 See Lina Saigol, 'Schaeffler and Continental: Hostile Bid Used Loophole' *Financial Times* (25 November 2008), <https://www.ft.com/content/8ee355ba-ba89-11dd-aecd-0000779fd18c>.

81 Directive 2013/50, of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC, 2013 OJ (L 294) 13 (EU) (hereinafter Amending Directive).

82 Directive 2004/109, of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, 2004 OJ (L 390) 38 (EC) (hereinafter Transparency Directive).

83 Westlaw Practical Law Corporate, 'Transparency Directive: Overview, Practical Law UK Practice Note Overview 3-205-8035', *Thomson Reuters Practical Law* (2022), <https://uk.practicallaw.thomsonreuters.com/3-205-8035?transitionType=Default&contextData=(sc.Default)>; Eur Sec Mkts Auth, Final Report on Draft Regulatory Technical Standards on Major Shareholdings and an Indicative List of Financial Instruments Subject to Notification Requirements Under the Revised Transparency Directive 39 (2014), <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1187_final_report_on_draft_rts_under_the_transparency_directive_0.pdfh> (noting that the revised Transparency Directive 'expands the scope of disclosure' and 'explicitly addresses the case of cash-settled equity derivatives, the omission of which can be characterized as a main regulatory failure of the previous regime').

Matrix: Comparative Treatment of Cash-Settled Equity Derivatives Holdings

Jurisdiction	Initial Disclosure Threshold	Coverage of Cash-Settled Equity Derivatives	Conditions to Coverage of Cash-Settled Equity Derivatives	Initial Filing Deadline
UK: Disclosure and Transparency Rules Regime	3% (delta-adjusted) (UK issuers) 5% (delta-adjusted) (non-UK issuers)	Yes	No	two trading days (UK issuers) & four trading days (non-UK issuer)
UK: Takeover Code Regime	1%	Yes	No	3:30 pm on tenth business day after commencement of offer
Australia	5% (delta-adjusted)	Yes	No	two business days or, in bid period, by 9:30 am next trading day
Canada	10% (or 5% if under take-over bid)	Yes	Yes: if formal or informal ability to obtain shares or direct voting	news release “promptly” (by next day trade open) & report “promptly” (no later than two business days)
France	5%	Yes	No	four trading days
Germany	3% (applies only to holdings of voting rights) 5% (calculated by aggregating holdings of voting rights and financial instruments such as cash-settled equity swaps) (delta-adjusted)	Yes	No	without undue delay (no later than four trading days)
Hong Kong	5% (delta-adjusted)	Yes	No	three business days

Ireland	3% (delta-adjusted) (Irish issuers) 5% (delta-adjusted) (non-Irish issuers)	Yes	No	two trading days (Irish issuers) & four trading days (non-Irish issuers)
Italy	3% (applies *only* to "actual" voting rights or shares) 5% (calculated by aggregating "actual" voting rights or shares plus equity financial instruments such as cash-settled derivatives (delta-adjusted))	Yes	No	four trading days
Netherlands	3% (delta-adjusted) (Dutch companies) 5% (delta-adjusted) (non-Dutch companies)	Yes	No	without delay
Switzerland	3%	Yes	No	four trading days
US – Current 13D	5%	No	Not applicable	ten days
US – Proposed 13D	5%	Yes	Yes: purpose or effect re control	five days
US – Proposed 10B	either (a) "security-based swap position" of $300 million (delta-adjusted); or (b) "security-based swap equivalent position" of 5%	Yes	No	"promptly" but no later than end of business day following execution of swap

establishment of an initial disclosure threshold of 5 per cent (delta-adjusted) for financial instruments, including swaps and contracts for difference, that have 'similar economic effect' to ownership of shares.[84] This amendment was intended to capture cash-settled equity swaps and thereby address hidden (morphable) ownership, in accordance with suggestions from the European Commission and the Committee of European Securities Regulators, the predecessor to the European Securities and Markets Authority.[85] The amended Transparency Directive covers all cash-settled equity derivatives.[86] No formal or informal right to direct the voting or obtain shares is a condition to disclosure.[87] The filing must be made 'promptly' but no later than four trading days after the pertinent acquisition.[88] The Transparency Directive further requires that the information contained in the notification be made publicly available, by the issuer or the Member State's competent authority, upon receipt but no later than three trading days after receipt.[89]

Australia

Chapter 6C of the Australian Corporations Act requires that an investor's 'relevant interest' that totals 5 per cent (a 'substantial holding') or more in a listed public company be disclosed to the company.[90] Relevant interest is defined as 'holding or controlling voting or disposal of securities no matter how remote the relevant interest is or how it arises'.[91] The

84 See Amending Directive (n 81) 21–22; see also Transparency Directive (n 83) arts 9, 13, at 47, 49.

85 See *Commission Proposal for a Directive of the European Parliament and of the Council Amending 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 and Commission Directive 2007/14/EC*, at 5, 19, COM (2011) 683 final (25 October 2011) (proposing these amendments to the Transparency Directive); *Commission Staff Working Document on the Review of the Operation of Directive 2004/109/EC: Emerging Issues*, at 3, SEC (2009) 611 (27 May 2010), <https://op.europa.eu/en/publication-detail/-/publication/f61654b8-250f-4e3a-8ea7-c63877d17c37/language-en>; Comm Eur Sec Reguls, Consultation Paper: Proposal to Extend Major Shareholding Notifications to Instruments of Similar Economic Effect to Holding Shares and Entitlements to Acquire Shares 7 (2010), <https://www.esma.europa.eu/sites/default/files/library/2015/11/09_1215b.pdf>; Eur Sec Mkts Auth, Consultation Paper on Draft Regulatory Technical Standards on Major Shareholdings and Indicative List of Financial Instruments Subject to Notification Requirements Under the Revised Transparency Direct 7 (2014), <https://www.esma.europa.eu/document/draft-regulatory-technical-standards-major-shareholdings-and-indicative-list-financial>.

86 This is supported by major law firms. See *UK/EU Investment Management Update (September 2021)*, Sidley Austin (10 September 2021), <https://www.sidley.com/en/insights/newsupdates/2021/09/ukeu-investment-management-update-september-2021#5> ('Under the Transparency Directive, a shareholder who acquires or disposes of shares that are admitted to trading on a regulated market and to which voting rights are attached must inform the relevant national competent authority (NCA) and the issuer when certain thresholds are reached. The notification obligation also applies in respect of financial instruments with similar economic effect to holding shares or entitlements to acquire shares (i.e., either cash-settled or physically settled derivatives); European Regulatory Snapshot: The Amended Transparency Directive, Davis Polk (24 October 2013), <https://www.davispolk.com/sites/default/files/10.24.13.European.Regulatory.Snapshot.pdf> ('the notification regime for major holdings of voting rights has been extended to include direct and indirect holdings of financial instruments having the same economic effect as the holding of shares, whether or not they confer a right of physical settlement'); *European Commission Announces Revisions to the Transparency Directive*, Cadwalader (16 November 2011), <https://www.cadwalader.com/resources/clients-friends-memos/european-commission-announces-revisions-to-the-transparency-directive> ('this is a legislative response to recent instances of investors acquiring controlling stakes in listed companies without having to inform the markets as a result of using financial instruments such as cash-settled derivatives').

87 See Amending Directive (n 81) 21–22 (amending Art 13 of the Transparency Directive to include cash-settled instruments); Transparency Directive (n 82) art 13, at 49.

88 See Amending Directive (n 81) 21 (amending Art 12 of the Transparency Directive to require notification to be made promptly but no later than four trading days after the triggering of the notification requirement); Transparency Directive (n 83) art 12, at 48.

89 See Transparency Directive (n 82) art 12, at 48–49.

90 Corporations Act 2001, Sections 9 and 671B(1) (AUS), <https://www.legislation.gov.au/Details/C2018C00031> (defining substantial holding, which is what must be disclosed at 5%) (hereinafter Corporations Act 2001).

91 Australia Securities & Investment Commission, Relevant Interests and Substantial Holding Notices (November 2013), <https://download.asic.gov.au/media/1236706/rg5-published-20-december-2013.pdf>.

notice to the company must be given within 2 business days after the company becomes aware of the information or, if there is a takeover bid, by 9:30 am on the next trading day.[92]

Until recently, it was uncertain whether cash-settled derivatives constituted a relevant interest under Chapter 6C. To address this, in 2021, the Takeovers Panel issued Guidance Note 20. The Guidance provided that, irrespective of whether such derivatives constituted a 'relevant interest' and whether a control transaction has commenced, all equity derivative positions, including cash-settled ones, of 5 per cent or more (delta-adjusted) would be required to be disclosed.[93] Disclosure must be made within two business days of becoming aware or, in a bid period, by 9:30 am on the next trading day.[94]

Canada

The Canadian Securities Administrators (CSA) is an umbrella organization of the provincial and territorial securities regulators that seeks to coordinate and harmonize regulation.[95] The CSA's National Instrument 62-104 on Take-Over Bids and Issuer Bids has a disclosure trigger of 10 per cent and 5 per cent if the company is under a takeover bid.[96] In 2016, the CSA, after having initially proposed including all equity derivatives that would substantially replicate the economic consequences of ownership for the purposes of the trigger, decided not to do so.[97] Instead, the CSA added guidance in National Policy 62-203 regarding the circumstances under which an investor may have to include in the threshold calculation an 'equity swap or similar derivative arrangement', stating that '[t]his could occur' where the investor 'has the ability, formally or informally, to obtain the voting or equity securities or to direct the voting of voting securities held by any counterparties to the transaction'.[98] An investor with a disclosure obligation is required to file two documents. The first is a news release that must be filed 'promptly', at the latest by 'the opening of trading on the business day following the acquisition'.[99] The second is a report that must be filed 'promptly', at the latest by '2 business days from the date of the acquisition'.[100]

France

In France, any financial instrument with an economic effect that is similar to owning shares counts towards the disclosure threshold, irrespective of whether the instrument has any formal or informal voting rights.[101] The Autorité Des Marchés Financiers (AMF) rules

92 Corporations Act 2001 (n 90) at Section 671B(1)(6).

93 Australian Government Takeovers Panel, Guidance Note 20—Equity Derivatives (2021), at ¶ 2, ¶ 7, ¶ 9, <https://www.takeovers.gov.au/content/Guidance_Notes/Current/downloads/GN20_2021.pdf>.

94 Ibid ¶ 16.

95 Canadian Securities Administrators, *About*, <https://www.securities-administrators.ca/about/> accessed 20 August 2022.

96 See Canadian Securities Administrators, National Instrument 62-104: Take-Over Bids and Issuer Bids, Section 5.2 (2016) (unofficial consolidation), <https://www.osc.ca/sites/default/files/2020-10/ni_20160509_62-104_unofficial-consolidation.pdf> (hereinafter Canadian Early Warning System).

97 Canadian Securities Administrators, CSA Notice of Amendments to Early Warning System 6 (February 2016), <https://www.justice.gov.nt.ca/en/files/securities-regulatory-instruments/6/62-104/62-104.2016-02-25.01.en.pdf>

98 Canadian Securities Administrators, National Policy 62-203 Take-Over Bids and Issuer Bids, Section 3.1 (unofficial consolidation), <https://www.osc.ca/sites/default/files/pdfs/irps/np_20160509_62-203_take-over-bids.pdf>.

99 Canadian Early Warning System (n 96) at Section 5.2(1)(a).

100 Ibid Section 5.2(1)(b).

101 Autorité Des Marchés Finaciers, General Regulations, art 223-11 (III), (5 December 2015), <https://www.amf-france.org/en/eli/fr/aai/amf/rg/article/223-11/20151205/notes> (hereinafter AMF General Regulations); Code de Commerce [C com]

explicitly require disclosure of all 'equity swaps', defined to include both physically settled and cash-settled equity swaps.[102] The initial disclosure threshold is 5 per cent of the total voting power.[103] The deadline for disclosure is within four trading days.[104] French entities can include bylaw requirements to disclose to them holdings as low as 0.5 per cent (calculated the same way) but these disclosures would only be made to the issuer and not to the AMF or to the public.[105]

Germany

In Germany, derivatives such as cash-settled contracts for difference and cash-settled equity swaps count towards an initial disclosure threshold of 5 per cent (delta-adjusted) for financial instruments—and towards an intial disclosure threshold of 5 per cent for aggregated holdings of voting rights and financial instruments—while holdings of voting rights are subject to a lower initial disclosure threshold of 3 per cent.[106] Long positions are not netted for short positions.[107] Simultaneous notification to the issuer and BaFin must be made 'without undue delay' but no later than four trading days after the triggering of the

[Commerical Code] art 233-9 (I)(4) (Fr.) [hereinafter 'French Commercial Code']; See also Eric Cafritz, Olivier Genicot and Julie Bensaid, *France Amends Shareholder Disclosure Requirements to Include Cash-Settled Derivatives—Updated*, Fried Frank (17 April 2012), <https://www.friedfrank.com/siteFiles/Publications/4-17-2012%20-%20TOC%20Memo%20-%20France%20Amends%20Shareholder%20Disclosure%20Requirements.pdf> ('[the French will extend] the scope of existing shareholding disclosure rules to require the disclosure of positions held through agreements or derivative instruments settled in cash whose terms are referenced to an issuer's shares or voting rights and which give rise to a long position on the economic performance of underlying shares or voting rights').

102 AMF General Regulations (n 101) art 223-11 (III). That cash-settled swaps are included is supported by law firms. See eg, Herbert Smith Freehills, *New French Law to Aggregate Cash-Settled Securities for Threshold Crossing Disclosure Obligations* (6 March 2012), <https://hsfnotes.com/fsrandcorpcrime/2012/03/06/new-french-law-to-aggregate-cash-settled-securities-for-threshold-crossing-disclosure-obligations/> ('On 29 February, the French General Assembly passed a bill, known as the bill for "simplification of the law and facilitation of administrative processes", which provides for the aggregation of cash-settled securities as part of the calculation of thresholds crossing disclosure obligations.'). The French regulation includes other instruments as well—the list includes bonds exchangeable for, or redeemable in, shares (as well as, depending on their terms, convertible bonds), futures/forwards, options regardless of the trigger price, warrants, pension, temporary assignment agreements (such as a loan), CFDs, swaps and any financial instrument exposed to a basket or an index of shares of several issuers. See Ordonnance n° 2015-1576 du 3 décembre 2015 portant transposition de la directive 2013/50/UE du Parlement européen et du Conseil du 22 octobre 2013 modifiant la directive 2004/109/CE du Parlement européen et du Conseil sur l'harmonisation des obligations de transparence concernant l'information sur les émetteurs dont les valeurs mobilières sont admises à la négociation sur un marché réglementé [Ordinance Implementing Amending Directive] Journal Officiel de la République Française [J.O] [Official Gazette of France], 30 January 2016, 42, <https://www.legifrance.gouv.fr/download/pdf?id=DDFu1oV3ciYyRuFXbi0DbFAW5DMsc6YexrrQDP8QOb0= (Fr.)>.

103 French Commercial Code (n 101) at art 233-7 (I).

104 AMF General Regulations (n 101) art 223-14 (I). As with Trade Directive II, the calculation of equity is made on a delta-adjusted basis. The delta-adjusted basis is calculated on a generally accepted standard pricing model generally used in the finance industry for that financial instrument and integrating elements relevant to the financial instrument's valuation such as interest rate and dividends payments. See ibid art 223-11 (III).

105 French Commercial Code (n 101) art 233-7 (III). Most of the blue-chip companies listed on France's CAC40 index have this low threshold. See Simmons + Simmons, *The French Way: Shareholder Reporting Obligations in France* (21 April 2016), <https://www.simmons-simmons.com/en/publications/ck0b0sylm776q0b94y7flvoxu/21-the-french-way-shareholder-reporting-obligations-in-france#1>.

106 See BaFin, Issuer Guidelines: Modul B II, 42–43, 47 (2018), <https://www.bafin.de/SharedDocs/Downloads/EN/Leitfaden/WA/dl_emittentenleitfaden_einleitung_en.html?nn=12655158> (hereinafter BaFin Issuer Guidelines); *Major Holdings of Voting Rights*, BaFin (1 January 2022), https://www.bafin.de/EN/Aufsicht/BoersenMaerkte/Transparenz/Informationspflichten_fuer_Emittenten/BedeutendeStimmrechtsanteile/bedeutendestimmrechtsanteile_node_en.html>; see also Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], 9 September 1998, Bundesgesetzblatt, Teil I [BGBl I] at 43–44, 47–48, as amended, § 33–34, 38–39 (Ger).

107 See Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], 9 September 1998, BGBl I at 47–48, as amended, § 38, no 4 (Ger); BaFin Issuer Guidelines (n 106) 17, 46–47.

disclosure threshold.[108] Domestic issuers must then publish the information they receive by providing notifications to the media 'without undue delay' and no later than three trading days after receiving a notification.[109]

Hong Kong

Hong Kong has two disclosure regimes, depending on whether the listed corporation is in an offer period. The primary disclosure regime, which applies to all investors, requires investors to disclose any 'interest' in the voting shares of a corporation that exceed 5 per cent.[110] Equity derivatives count towards this 5 per cent disclosure threshold (delta-adjusted), 'regardless of whether [the derivatives] are physically settled, by delivery of the underlying shares, or cash settled'.[111] Only long positions are considered for the purposes of the calculation and short positions are not deducted.[112] The disclosure must occur within three business days by notifying the Hong Kong Stock Exchange, which subsequently publishes it.[113]

Investors are subject to an additional disclosure regime during offer periods, which begins when an announcement is made of a proposed or possible offer.[114]

Ireland

Ireland has two disclosure regimes, depending on whether the corporation is in an offer period. The primary disclosure regime, which applies to all investors regardless of whether there is a pending offer, requires that all financial instruments that reference shares to which voting rights are attached, including cash-settled derivatives, count towards the calculation of disclosure thresholds.[115] Indeed, when Ireland expanded its disclosure laws to

108 See Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], 9 September 1998, BGBl I at 43, § 33, no 1 (quoting the unofficial translation of the WpHG). The WpHG specifies that the notification period begins when a party learns or should have learned of the reaching or exceeding of a disclosure threshold and that there is an 'irrefutable presumption' that a party learns of their notification requirement within two days of the triggering of a threshold. Ibid. (quoting the unofficial translation of the WpHG). While the WpHG thus technically allows for up to six days for a party subject to a notification requirement to fulfil this requirement, the expectation and actual practice is to provide notification within four trading days of triggering a threshold. See Eur Sec & Mkts Auth, Practical Guide: National Rules on Notifications of Major Holdings Under the Transparency Directive 30 n15 (2022), <https://www.esma.europa.eu/sites/default/files/library/practical_guide_major_holdings_notifications_under_transparency_directive.pdf>.

109 *Major Holdings of Voting Rights*, BaFin (1 January 2022), <https://www.bafin.de/EN/Aufsicht/BoersenMaerkte/Transparenz/Informationspflichten_fuer_Emittenten/BedeutendeStimmrechtsanteile/bedeutendestimmrechtsanteile_node_en.html>; see also Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], 9 September 1998, BGBl I at 48, § 40, no 1. Issuers must also provide the notifications to the German Company Register for storage. See *Major Holdings of Voting Rights* above.

110 Securities and Futures Ordinance, (2021) Cap 571, 15-30, § 311(H.K.).

111 Hong Kong Securities and Futures Commission, *Outline of Part XV of The Securities And Futures Ordinance* 10 (2017), <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/outline-of-part-xv-of-the-securities-and-futures-ordinance-cap571-disclosure-of-interests/outlineofpartxvofthesecuritiesandfuturesordinancecap571disclosureofinterests.pdf>. Indeed, the Hong Kong Securities and Futures Commission's guidance on disclosing interests expressly states that an investor has an 'interest' in voting shares if they 'enter into a contract [including equity derivatives] that gives [the investor] a right to shares, a right of first refusal of shares, or to *a payment in the event of a change in the price of shares*'. Ibid 7 (emphasis added).

112 Ibid 14–16.

113 Ibid 66–67, 83.

114 Hong Kong Securities and Futures Ordinance, *The Codes on Takeovers and Mergers and Share Buy-Backs* Def-12, TC-22.1 (2018), <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/the-codes-on-takeovers-and-mergers-and-share-buy-backs/the-codes-on-takeovers-and-mergers-and-share-buy-backs.pdf>.

115 Transparency (Directive 2004/109/EC) (Amendment) (No 2) Regulations 2015 (SI 541/2015)(Ir.) at Citation 15, <http://www.irishstatutebook.ie/eli/2015/si/541/made/en/pdf> ('The notification requirements under Regulation 14(1) shall also apply to a person who holds, directly or indirectly . . . financial instruments which [do not give the holder either the unconditional right to acquire or the discretion to acquire shares to which voting rights are attached] but which are referenced to [shares to which voting rights are attached] and with *economic effect* similar to that of the financial instruments [which give the holder either the

capture cash-settled derivatives, it specified that options, futures, swaps, contracts for differences and 'any other contracts or agreements with similar economic effects which may be settled physically or in cash' are considered financial instruments for the purposes of calculating whether an investor has triggered the disclosure threshold.[116]

For Irish issuers, the initial disclosure threshold is 3 per cent (delta-adjusted) and for non-Irish issuers, it is 5 per cent (delta-adjusted).[117] Only long positions are taken into account and short positions are not netted against the long positions.[118] On reaching these thresholds, the investor in Irish issuers has two trading days to notify the issuer, and the investor in non-Irish issuers has four trading days.[119] After receipt of the information, the issuer has three trading days to make the information public.[120]

An additional disclosure regime applies when a corporation's shares are the subject of an offer period, which begins at the announcement of an offer.[121]

Italy

Italy's disclosure rules impose different disclosure thresholds based on whether the investor has 'actual' holdings (ie, voting shares and voting rights) or a combination of actual holdings and equity investments in financial instruments. An investor must disclose their actual holdings once those holdings reach a disclosure threshold of 3 per cent.[122] However, an investor must disclose their actual holdings and equity investments in financial instruments, which include cash-settled derivatives, once the aggregate of those kinds of investments reaches a disclosure threshold of 5 per cent (delta-adjusted), whether or not the investor's actual holdings alone reach the 3 per cent disclosure threshold referenced earlier.[123] Put simply, Italy's disclosure laws 'will *de facto* require that cash-settled derivatives be disclosed starting from a 5 per cent threshold'.[124] Regardless of which threshold is triggered, the

unconditional right to acquire or the discretion to acquire the shares], whether or not they confer a right to physical settlement') (emphasis added). See also Arthur Cox, *Ireland: Changes to Transparency Regime*, Mondaq (16 December 2015), <https://www.mondaq.com/ireland/commoditiesderivativesstock-exchanges/451914/changes-to-transparency-regime> ('[T]he disclosure obligation has been widened to cover holdings of all financial instruments that could be used to acquire economic interests in a listed company (in particular cash-settled derivatives)').

116 Transparency (Directive 2004/109/EC) (Amendment) (No 2) Regulations 2015 (SI 541/2015)(Ir.) at Citation 15, <http://www.irishstatutebook.ie/eli/2015/si/541/made/en/pdf>.

117 Central Bank (Investment Market Conduct) Rules 2019 (SI 366/2019) (Ir.) at Regulation 13, <http://www.irishstatutebook.ie/eli/2019/si/366/made/en/print?q=366>.

118 Transparency (Directive 2004/109/EC) (Amendment) (No 2) Regulations 2015 (SI 541/2015)(Ir.) at Citation 15, <http://www.irishstatutebook.ie/eli/2015/si/541/made/en/pdf>.

119 Central Bank (Investment Market Conduct) Rules 2019 (SI 366/2019) (Ir.) at Regulation 14(1)(a), <http://www.irishstatutebook.ie/eli/2019/si/366/made/en/print?q=366>.

120 Transparency (Directive 2004/109/EC) Regulations 2007 (SI 277/2007)(Ir.) at Regulation 21(9), <http://www.irishstatutebook.ie/eli/2007/si/277/made/en/pdf>.

121 Irish Takeover Panel, *Takeover Rules and Substantial Acquisition Rules* A7, 2.18 (2022), <https://irishtakeoverpanel.ie/wp-content/uploads/2022/07/Takeover-Rules.pdf>.

122 CONSOB Regulation No 11971 Art 117 (2022).

123 Ibid art 119; see also Clifford Chance, 'New Transparency Regime for Cash-Settled Derivatives' 3 (2011), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2011/09/new-transparency-regime-for-cashsettled-derivatives.pdf> ('This approach should allow greater transparency as to cash-settled derivatives, to the extent they are used to acquire material economic interests').

124 Jones Day, 'New Equity Disclosure Rules for Italian Listed Companies' (*University of Oxford Faculty Law: Oxford Business Law Blog*, (12 August 2016), <https://www.law.ox.ac.uk/business-law-blog/blog/2016/08/new-equity-disclosure-rules-italian-listed-companies> ('[A] new definition of "Aggregate Equity Investment,". . . which comprises Actual Holdings and Equity Investment in Financial Instrument . . . will *de facto* require that cash-settled equity derivatives be disclosed starting from a 5 percent threshold.').

investor must notify the investee and the Italian Companies and Exchange Commission (CONSOB) within four trading days.

Netherlands

Holdings of cash-settled equity swaps count towards the disclosure threshold.[125] The thresholds are 3 per cent (delta-adjusted) (with issuers incorporated under Dutch law and certain other entities) and 5 per cent (delta-adjusted) (with certain entities not incorporated under Dutch law).[126] Notification must be made to the Netherlands Authority for the Financial Markets (AFM), which reports the information to the issuer immediately, processes the data, and publishes the data in its publicly available database.[127] Notification must be made 'without delay' after a person becomes aware or should have become aware of reaching the 3 per cent threshold.[128]

Switzerland

Switzerland has two blockholder disclosure regimes: a generally applicable disclosure regime and an additional disclosure regime that applies during public tender offers.[129] The general disclosure regime requires notification when a person reaches or exceeds 3 per cent of the voting rights of a company.[130] The FINMA Financial Market Infrastructure Ordinance (FinMIO-FINMA) provides that equity derivatives that are designed for or permit cash settlement and contracts for difference count towards a disclosure threshold of 3 per cent (nominal).[131] According to the Disclosure Office of the SIX Swiss Exchange, which is responsible for monitoring compliance with notification requirements relating to companies listed on the SIX Swiss Exchange,[132] equity derivatives with cash settlement

125 See Autoriteit Financiële Markten (AFM) [Netherlands Authority for the Financial Markets], Guideline for Shareholders 28–30 (2021), <https://www.afm.nl/en/professionals/doelgroepen/effectenuitgevende-ondernemingen/meldingen/substantieel> [hereinafter AFM Guidelines]; Tom van Wijngaarden and others, *Corporate M&A 2022: Netherlands*, Chambers & Partners (21 April 2022), <https://practiceguides.chambers.com/practice-guides/corporate-ma-2022/netherlands>.

126 AFM Guidelines (n 125) [137], 7, 10–11 (noting to which issuers the 5% threshold applies); ibid 32 (noting that the delta-adjusted calculation method applies to cash-settled financial instruments).

127 Ibid 39–41. Subject to the potential suspension of the processing of the notification due to incorrect or incomplete information, the AFM will process and publish the data within one working day. See ibid 41.

128 See ibid 39. According to the AFM, notification is made without delay when, in light of the circumstances, the time between when a person learns or should learn of their notification obligation and when the person submits the notification is as short as possible. See ibid. The AFM presumes that a person should know of their notification obligation within two days of reaching the 3% threshold. See ibid.

129 See Frank Gerhard and others, *Corporate M&A 2022: Switzerland*, Chambers & Partners (21 April 2022), <https://practiceguides.chambers.com/practice-guides/comparison/665/8607/13842-13846-13853-13856-13863-13869-13881-13886-13892-13898-13902>; Claude Lambert and others, 'Switzerland' in Alan M Klein (ed), *Getting the Deal Through: Public M&A* (2022) 11–12, <https://www.homburger.ch/api/ms/2022/06/_/2022-Public-MA-Switzerland-002.pdf>.

130 See Bundesgesetz über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten- und Derivatehandel [Finanzmarktinfrastrukturgesetz, FinfraG] [Financial Market Infrastructure Act, FinMIA] 19 June 2015, AS 5339 (2015), art 120, para 1 (Switz); Gerhard and others (n 129).

131 See Verordnung der Eidgenössischen Finanzmarktaufsicht über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten- und Derivatehandel [Finanzmarktinfrastrukturverordnung-FINMA, FinfraV-FINMA] [FINMA Financial Market Infrastructure Ordinance, FinMIO-FINMA] 3 December 2015, AS 5509 (2015), arts 14, 15 (Switz); see also SIX Exchange Regulation, Disclosure Office Notice: Disclosure of Equity Derivatives 5–6 (2018) (hereinafter Equity Derivatives Disclosure Notice), <https://www.ser-ag.com/dam/downloads/regulation/disclosure-shareholdings/notices/disclosure-notice-ii-13-en.pdf>; Gerhard and others (n 129) (noting that the disclosure requirement applies to shares and derivatives, including cash-settled derivatives).

132 See Six Exchange Regulation, Rules for the Disclosure Office of SIX Swiss Exchange 3 (2021), <https://www.ser-ag.com/dam/downloads/regulation/disclosure-shareholdings/rules-disclosure-office-en.pdf> (noting that FinMIO-FINMA requires stock exchanges in Switzerland to establish disclosure offices to monitor compliance with shareholdings disclosure and publication

count towards the disclosure threshold when the price performance of the instruments is largely influenced by the underlying.[133] As a general rule, long and short positions are not netted.[134] The notification must be received by the company and the relevant disclosure office within four trading days of the triggering of a threshold.[135]

In public tender offers, additional notification requirements apply.[136]

United Kingdom

The United Kingdom has two blockholder disclosure regimes. One is the regime under the City Code on Takeovers and Mergers (City Code) that applies in the context of companies 'under offer'. The second is the regime under Rule 5 of the Disclosure and Transparency Rules (DTR) that applies to investors generally, even investors who are required to make disclosures under the City Code.

Rule 5 of the DTR requires that all direct and indirect holdings of financial instruments referenced to shares and with a similar economic effect to shares with voting rights count towards the disclosure threshold, whether or not they convey a right to physical settlement.[137] This covers cash-settled derivatives.[138] The initial disclosure threshold is 3 per cent (delta-adjusted) for UK issuers and for non-UK issuers, 5 per cent (delta-adjusted).[139] The notification must be made 'as soon as possible', and no later than two trading days for a UK-based issuer and four trading days for a non-UK issuer after learning of (or should have learned of) the acquisition.[140]

obligations); Gerhard and others (n 129) (noting that the SIX Swiss Exchange is Switzerland's main stock exchange); see also Verordnung der Eidgenössischen Finanzmarktaufsicht über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten- und Derivatehandel [Finanzmarktinfrastrukturverordnung-FINMA, FinfraV-FINMA] [FINMA Financial Market Infrastructure Ordinance, FinMIO-FINMA] 3 December 2015, AS 5509 (2015), art 27, para 3 (authorizing disclosure offices of stock exchanges to issue communications and regulations when necessary to fulfil the purpose of FinMIO-FINMA); Urs Brügger and Rashid Bahar, 'Amended Disclosure Regime for Major Shareholdings', *Bär & Karrer* (11 January 2016), <https://www.baerkarrer.ch/en/publications/amended-disclosure-regime-for-major-shareholdings> (noting that the Disclosure Office reports any breaches to FINMA, which, upon reviewing the report, may forward the case to the Federal Department of Finance for enforcement).

133 See Equity Derivatives Disclosure Notice (n 131), at 6. The percentage of voting rights relating to cash-settled equity derivatives generally must be calculated on a nominal basis (the number of shares that the equity derivatives relate to). See ibid. However, the Disclosure Office recognizes that there may be cases where the number of shares relating to equity derivatives is uncertain at the time when the notification requirement arises and has provided guidance on how parties may calculate the percentage under these circumstances. See ibid 7–8.

134 See ibid 5.

135 See Verordnung der Eidgenössischen Finanzmarktaufsicht über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten- und Derivatehandel [Finanzmarktinfrastrukturverordnung-FINMA, FinfraV-FINMA] [FINMA Financial Market Infrastructure Ordinance, FinMIO-FINMA] 3 December 2015, AS 5509 (2015), art 24 (Switz); Equity Derivatives Disclosure Notice (n 131), 8; Olivier Favre and Tarek Houdrouge, 'Switzerland' in Rafal Gawlowski (ed), *Getting the Deal Through: Equity Derivatives* (Lexology 2021) 75, 81, <https://www.swlegal.com/media/filer_public/59/38/59388b46-8e4c-47fe-8c48-c793089d6531/2021_equity_derivatives_switzerland.pdf>.

136 Bundesgesetz über die Finanzmarktinfrastrukturen und das Marktverhalten im Effekten- und Derivatehandel [Finanzmarktinfrastrukturgesetz, FinfraG] [Financial Market Infrastructure Act, FinMIA] 19 June 2015, AS 5339 (2015), art 134; Gerhard and others (n 129).

137 Financial Conduct Authority, Disclosure Guidance and Transparency Rules sourcebook, Ch 5.1.2R(1) and Ch 5.3.1R(1) (August 2022), <https://www.handbook.fca.org.uk/handbook/DTR/5.pdf> (hereinafter FCA Handbook).

138 Ashurst, *Disclosure of Equity Derivatives: Amendments to Transparency Directive Implemented in the UK* (1 December 2015) <https://www.ashurst.com/en/news-and-insights/legal-updates/disclosure-of-equity-derivatives–-amendments-to-transparency-directive-implemented-in-the-uk/> ('The UK extended the scope of its disclosure regime in 2009, so as to require disclosure of long positions held through cash-settled derivatives').

139 FCA Handbook (n 137) Ch 5.1.2R(1) and Ch 5.3.3AR (August 2022), <https://www.handbook.fca.org.uk/handbook/DTR/5.pdf>.

140 Ibid Ch 5.8.3R.

For a UK-registered company[141] ‘under offer’ (as defined under the City Code), that is listed on a UK exchange any person that is directly or indirectly ‘interested’ in 1 per cent or more of any class of securities of the company must make an ‘opening position disclosure’.[142] An investor that is party to ‘any derivative’ that has the economic effect of a long position in the shares is treated as having such an interest.[143] In the disclosure forms, companies are required to disclose cash-settled and physically settled derivatives.[144] Disclosure must be made before 3:30 pm on the tenth business day after the offer has commenced.[145]

D. *How the SEC's approach fails to address hidden (morphable) ownership and undermines corporate governance: the promise of an alternative approach*

1. Overview

Considered at the 10,000-foot level, the proposed extension of blockholder disclosure to cash-settled synthetic equity holdings is welcome and long overdue. However, I believe there is a fundamental problem with the SEC's proposed architecture, namely the conjunction of (a) the contemplated *situs* of cash-settled equity swaps in the Schedule 10B regime and (b) how the SEC treats the two regimes as regulatory *silos*, rather than in a holistic way. This silo/situs problem results in an overall regulatory architecture that is not only largely disconnected with the goal of addressing the hidden (morphable) ownership phenomenon but, importantly, also affirmatively undermines corporate governance. This situs/silo problem is discussed in Part II.D.2.

Beyond undermining corporate governance and causing a disconnect with the goal of addressing hidden (morphable) ownership, the situs/silo problem introduces startling regulatory asymmetries. How direct equity holdings and synthetic equity holdings are treated are widely different and how different kinds of synthetic equity holdings are treated are also widely different. These asymmetry issues will be discussed in Part II.D.3.

I suggest a fundamental, yet simple, change to the regulatory architecture that would be responsive to the hidden (morphable) ownership phenomenon and corporate governance considerations, and avoid the startling regulatory asymmetries. This will be set forth in Part II.D.4.

141 The code applies to public companies registered in the UK with their registered office in the UK that are listed on a UK exchange. It also applies to UK-incorporated private companies who had previously issued a security among other provisions. See The Panel on Takeovers and Mergers (UK), The Takeover Code (24 July 2022), at Rule A3(a), <https://www.thetakeoverpanel.org.uk/wp-content/uploads/2022/07/343427_001_The-Take-Over_Bookmarked_13.07.22.pdf?v=14Jul2022> [hereinafter UK Takeover Code].

142 UK Takeover Code (n 141) Rule 8.3.

143 Ibid Rule C12(4).

144 See eg, *UK Regulatory Announcement, HSV: Millennium Partners, L.P.: Form 8.3 - HomeServe plc, FORM 8.3, PUBLIC OPENING POSITION DISCLOSURE/DEALING DISCLOSURE A PERSON WITH INTERESTS IN RELEVANT SECURITIES REPRESENTING 1% OR MORE, Rule 8.3 of the Takeover Code (the 'Code')* (22 August 2022), <https://www.bloomberg.com/press-releases/2022-08-22/hsv-millennium-partners-l-p-form-8-3-homeserve-plc>.

145 UK Takeover Code (n 141) at Rule Notes on Rule 8.2(a).

2. The situs/silo problem: the subjugation of the hidden (morphable) ownership goals

Historically, implementation of the hidden (morphable) ownership strategy has generally relied on the use of cash-settled equity swaps. But because of Section 766 of Dodd–Frank, the SEC was forced to engage in a form of statutory arbitrage in order to mandate disclosure of holdings of such swaps. In effect, the SEC gamed the virtual prohibition on SEC action to require disclosures of such holdings under the longstanding Section 13(d) regime by using the statutory predicate of Section 10B added by Dodd–Frank. Only holdings of other cash-settled synthetics, historically not usually relied on for the hidden (morphable) ownership strategy, would be covered by the revised Schedule 13D.

As a result, the situs for the typical implementation of the hidden (morphable) ownership strategy is the new Schedule 10B, a regulatory regime intended to address matters of fraud and manipulation and financial stability, not the corporate governance issues at the heart of the hidden (morphable) ownership phenomenon. Considerations outside the Schedule 10B silo, such as the deleterious impact Schedule 10B's features would have on corporate governance, were not considered. The combination of this situs and this silo mindset means that, overall, the bifurcated regulatory architecture has subjugated the need to properly address hidden (morphable) ownership and associated corporate governance complexities.

The most important example of this is in the area of filing deadlines. Classic blockholder disclosure rules, such as those adopted under the existing Section 13(d), have long recognized the need for a proper balance between the virtues of full and immediate transparency of holdings and the private and social benefits of stealth. The first decoupling article had a section titled, 'Toeholds and the Social Virtues of Stealth' and suggested that hidden (morphable) ownership may not always be socially undesirable.[146] If, for example, Section 13(d) required instant, real-time, disclosure of 5 per cent stakes, transparency and share pricing would improve, but the incentives and opportunities for investors to seek out bargains and possibly engage in activism would be diminished significantly.

In proposing the revised Schedule 13D, the SEC explicitly recognized that filing date requirements would need to strike this balance. The SEC stated that in enacting Section 13(d), 'Congress considered the need to strike an appropriate balance between, on the one hand, providing adequate disclosures to investors and, on the other hand, not unduly burdening those engaging in change of control transactions'.[147] In determining the filing deadline proposed for the revised Schedule 13D, the SEC emphasized that they 'continue to appreciate the need for a balance to be struck between the requirement that material information be timely disseminated and the competing interest that undue burdens not be imposed on the change in control context'.[148]

146 Hu and Black, 'Decoupling I (Southern Cal)' (n 1) 840–41.

147 Beneficial Ownership Release (n 8) 13,850.

148 Ibid 13,851.

Indeed, the SEC stated that it rejected a filing deadline shorter than the proposed five-day deadline because a shorter deadline 'could have more negative effects on shareholder activism'.[149] Moreover, towards the end of the Beneficial Ownership Release, the SEC requested comments on a variety of questions centred on the possible impact of the shortened filing deadlines on shareholder activism.[150]

The hidden (morphable) ownership strategy was uppermost in the SEC decision to extend the Rule 13d-3 definition to cover holders of certain cash-settled equity derivatives. In the CBA portion of this Release, three of the four heavily-footnoted paragraphs directly discussed the strategy and associated academic and other commentary.[151] The SEC recognized that while cash-settled security-based-swaps are excluded from the proposed amendments, 'the underlying mechanism for exercising influence over the voting, acquisition or disposition of reference securities is the same as for other cash-settled derivative securities'.[152] Towards the end of this Release, the SEC pointedly asked for data on the extent to which holders of derivative securities were able to acquire the 'matched shares' held by the derivatives dealers or have the ability to influence or direct the voting, acquisition or disposition of their derivatives dealers' matched shares—ie, the *Rubicon* and *CSX* issues.[153]

Schedule 10B requires that filings be made 'promptly' but no later than one business day after the date of the execution of the swap transaction filing deadline, far shorter than both the 5 days contemplated by the proposed Schedule 13D and the 10 days allowed by the existing Schedule 13D. Assuming *arguendo*, that the balance the SEC struck in the proposed Schedule 13D—the 5 days—was optimal and that the SEC's view than any shorter period could not be justified because of the unacceptable impact on shareholder activism, Schedule 10B's choice of at most one business day filing deadline cannot be appropriate on corporate governance grounds.

The SEC's CBA justification for Schedule 10B's tight deadline was rooted in large part on how prompt information on the holder's derivative holdings could help the holder's counterparties—eg, its derivatives dealers. The entire justification consisted of the following two sentences:

> The benefit of filing promptly would likely lead to increases in market and price efficiency as prices would reflect this information quickly. That is, [derivatives dealers] would be able to react quickly if warranted to this additional information by adjusting their security-based swap, underlying security, or related security positions, or margin requirements.[154]

Similarly, the costs side of the CBA focused on the impact on derivatives dealers, their customers, and others participating in the market for security-based swaps.[155]

149 Ibid 13,890.
150 Ibid 13,891 (para 92).
151 Ibid 13,886–87.
152 Ibid 13,887 n.261.
153 Ibid 13891 (para 95).
154 Swaps Release (n 8) 6,688.
155 Ibid 6,688–90.

Neither the benefits side nor the costs side of the SEC's Schedule 10B CBA analysis discussed any issues relating to shareholder activism or other aspects of corporate governance, much less the hidden (morphable) ownership phenomenon. Neither the fact that the at most one business day deadline may undermine shareholder activism nor the fact such a deadline was so different from existing or proposed Schedule 13D deadlines was mentioned and, presumably, was not considered.

The Schedule 10B filing deadline was basically set with the key goals of the Schedule 10B silo in mind: the impact of derivatives on the stability of financial institutions and on opportunities for fraud and manipulation. First, without referring to the 2021 collapse of Archegos Capital Management by name, the Swaps Release made clear that its large, non-transparent, security-based swap holdings and the sizable losses it inflicted on major banks on its default in 2021 was uppermost in the SEC's mind. Indeed, the SEC saw fit to give as an example of what it was concerned with: 'a single counterparty has a $5 billion security-based swap position distributed equally among five different dealers on the same underlying equity security' without any public reporting that would have alerted the dealers as to the total exposure of the counterparty.[156]

SEC Chairman Gary Gensler was more forthcoming than the Swaps Release as to the Swaps Release core concern over how derivatives threaten financial stability, and how the collapse of Archegos was the key motivating example. The SEC's press release associated with the Swaps Release stated, immediately after the first sentence:

> The 2008 crisis had many chapters, but a form of security-based swaps—credit default swaps—played a lead role throughout the story', said SEC Chair Gary Gensler. 'In March, when Archegos Capital Management collapsed, we saw once again the risks that might arise from the use of another security-based swap—total return swaps. As part of the Dodd-Frank Act of 2010, Congress granted this agency broad authority with respect to security-based swaps, including three important authorities we're acting upon here today.[157]

More generally, the SEC noted that large security-based swap positions may: (1) indicate that a person is building up a large security-based swap position, which may indicate potentially fraudulent or manipulative purposes, and (2) alert market participants and regulators as well as issuers of securities and their security holders to the risk posed by the concentrated exposures to a limited number of counterparties, which should inform those market participants and regulators of the associate risks, allow counterparties to risk manage and lead to better pricing of the swaps.[158]

The silo mindset of Schedule 10B is not only reflected in the filing deadline but also in the matter of threshold amounts, which also departs strikingly from those contemplated in the proposed Schedule 13D and existing Schedule 13D. In setting the threshold amounts

156 Swaps Release (n 8) 6,656.

157 See Press Release, Securities and Exchange Commission, SEC Proposes Rules to Prevent Fraud in Connection With Security-Based Swaps Transactions, to Prevent Undue Influence over CCOs and to Require Reporting of Large Security-Based Swap Positions (15 December 2021), <https://www.sec.gov/news/press-release/2021-259>.

158 Swaps Release (n 8) 6,667.

for the synthetic equity holdings covered by Schedule 10B, there was again a focus on its financial stability and fraud and manipulation concerns. The two primary justifications were:

> (1) Providing market participants (including counterparties, issuers, and issuers' stakeholders) and regulators with access to information that may indicate that a person (or a group of persons) is building up a large security-based swap position, which in some cases could be indicative of potentially fraudulent or manipulative purposes; and (2) alerting market participants and regulators to the existence of concentrated exposures to a limited number of counterparties, which should inform those market participants and regulators of the attendant risks, allow counterparties to risk mange and lead to better pricing of the security-based swaps with respect to the transactions with persons holding large positions in those security-based swaps ...[159]

The SEC does not discuss either how radically different the Schedule 10B notional amount thresholds are relative to the 5 per cent threshold in the proposed and existing Schedule 13D or how those amounts relate to the possible changes of corporate control at the heart of the hidden (morphable) ownership strategy. As result, the Schedule 10B thresholds are likely to be consistent with limiting hidden (morphable) ownership concerns through some highly unlikely coincidence.

The Schedule 10B filing deadline and threshold amounts thus largely reflect financial stability and fraud and manipulation concerns. They did not have in mind and, certainly as to the filing deadline and likely as to threshold amounts, the need for a balanced approach to hidden (morphable) ownership. Yet Schedule 10B, not the proposed Schedule 13D, is the exclusive situs for addressing the cash-settled equity swaps-based technique that is most commonly used in the hidden (morphable) ownership strategy. There is a startling disconnect between the ends of addressing hidden (morphable) ownership and the means available in Schedule 10B.

In other words, the situs/silo problem results in an overall regulatory architecture for cash-settled synthetic equity holdings that largely subjugates the vital need to address the hidden (morphable) ownership phenomenon in a manner cognizant of the delicate corporate governance issues involved. The best vehicle, Schedule 13D, is missing the key passenger—the cash-settled equity swap—while the other vehicle, Schedule 10B, is headed in a different direction—financial stability and fraud and manipulation.

3. The direct–synthetic and synthetic–synthetic asymmetries

The general case for direct–synthetic symmetric treatment in the takeover context is strong, as I have emphasized in my decoupling writings since 2006. Without this symmetry, for extended periods of time, activists using synthetics would be able to act on information not available to the public and not reflected in the share price. The integrity of, and confidence in, the stock market would be unduly undermined. Investors are not alerted to possible changes of control, and the market price may not reflect this reality. The playing field

159 Ibid.

between incumbent management and those who challenge incumbent management would be different from that contemplated by Section 13(d).

The SEC's approach to addressing hidden (morphable) ownership departs significantly from this generally desirable direct–synthetic symmetry and does so without providing any justification. In addition, the SEC departs from symmetry as between different kinds of synthetic holdings without any justification. As discussed earlier, the resulting extremely tight filing deadline, for instance, can significantly undermine activism, including activism that is both privately and socially valuable. This creates real vulnerabilities in CBA-based litigation.

In terms of scope, both the existing Schedule 13D and the proposed Schedule 13D need only be filed in a change of control context. Outside of this context, only the more abbreviated existing Schedule 13G/proposed Schedule 13G need be provided, and under their looser filing deadlines. In contrast, the Schedule 10B regime applies irrespective of whether there is a change of control context.

There are two kinds of asymmetry here. The direct–synthetic asymmetry flows from the fact that, irrespective of context, synthetic holdings covered by Schedule 10B would trigger an information-heavy/early filing regime but direct holdings would not. There is synthetic–synthetic asymmetry as well, flowing from synthetic holdings covered by Schedule 10B triggering the information-rich/early filing regime irrespective of context, but synthetic holdings covered by proposed Schedule 13D necessitate a change of control context.

In terms of the disclosure threshold, both the existing Schedule 13D and the proposed Schedule 13D contemplate a 5 per cent threshold. (I leave aside how the substantial change in the 'group' definition being proposed by the SEC would, in effect, significantly lower this 5 per cent threshold.) In contrast, Schedule 10B can be triggered simply by holding notional amounts in the requisite size. As shown in Part II.B.2, by looking at the median market capitalization of stocks in the S&P 500, a mere 1 per cent of an issuer can often trigger the filing requirement. Additionally, according to the estimates of major trade associations, the $300,000,000 notional amount threshold would fall below the 5 per cent threshold for over 2,100 companies.[160] These associations also note that most equity swaps reference the shares of large companies, thus increasing the significance of the notional amount threshold in comparison to the 5 per cent threshold.[161] Again, there is direct–synthetic asymmetry and synthetic–synthetic asymmetry.

In terms of filing dates, both the existing Schedule 13D and proposed Schedule 13D have far looser filing deadlines: initial filing deadlines of 10 days and 5 days, respectively.

160 Institute of International Bankers, International Swaps and Derivatives Association & Securities Industry and Financial Markets Association, Comment Letter on Proposed Rule 10B-1 Under the Securities Exchange Act of 1934 and Proposed Schedule 10B (21 March 2022), 27, <https://www.isda.org/a/VtPgE/SIFMA-ISDA-IIB-10B-1-Comment-Letter-File-No.-S7-32-10.pdf> [hereinafter *IIB-ISDA-SIFMA Letter*].

161 Ibid.

The initial filing deadline for Schedule 10B is 'promptly', but in no event later than the end of the next business day.

The SEC does not try to justify any of the foregoing direct–synthetic or synthetic–synthetic asymmetries. The re-engineering of the SEC approach that I next turn to would reduce these asymmetries and addresses the larger issue of how to properly deal with hidden (morphable) ownership.

4. A second-best alternative

As we have just seen, the SEC's approach fails to properly address the hidden (morphable) ownership phenomenon because of the situs/silo problem and creates unjustifiable asymmetries in regulatory treatment. I believe a partial solution lies in changing the characteristics of the silo for cash-settled equity swaps. Specifically, nothing in Section 766 would preclude the SEC from rewriting the Schedule 10B filing deadlines and threshold amounts to track the filing deadlines and threshold amounts set forth in the proposed Schedule 13D. Or, to simplify matters, and to accommodate future changes in Schedule 13D requirements, Schedule 10B could be written to automatically incorporate evolving Schedule 13D filing deadlines and threshold amounts.

The situs of cash-settled equity swaps remains at the new Schedule 10B. Such swaps would continue to be reported on and subject to the new Schedule 10B regime being proposed by the SEC (albeit with the 13D-type filing deadline and threshold amount). Consistent with Section 766, it is only other forms of synthetic equity that would be reported on Schedule 13D.

Three salutary effects would flow from the proposed dovetailing of the filing deadlines and threshold amounts of the new Schedule 10B to proposed Schedule 13D.

First and foremost, irrespective of the type of synthetic equity used, the hidden (morphable) ownership phenomenon would, in effect, be in significant measure addressed by a disclosure regime intended to address the phenomenon and associated corporate governance considerations. For instance, the filing deadline for all synthetic equity holdings would thus be driven by the Schedule 13D analysis relating to the optimal balance between market transparency and the need for activism—and not by concerns over financial stability and fraud and manipulation.

The SEC has only considered how to address the hidden (morphable) ownership phenomenon in a balanced way in the context of the proposed Schedule 13D. Irrespective of whether the SEC's particular proposals about filing dates and other matters strike the right balance among competing considerations, the SEC's proposed Schedule 13D tries to get it right.

This is not to suggest that the proposed Schedule 13D disclosure thresholds and filing dates are in fact optimal. Determining what would be optimal lies outside the decoupling theme of this article. It may be worth noting that, as shown in the matrix and narratives for the individual foreign jurisdictions set forth in this article, the filing deadlines overseas

tend to be shorter than the proposed five-day Schedule 13D deadline and, unlike the proposed Schedule 10B, none use a notional amount-based trigger.

Second, the direct–synthetic and synthetic–synthetic asymmetries are significantly reduced. Both direct and synthetic holdings would be subject to the same 5 per cent threshold and same 5-day filing deadline. And all synthetics would be treated identically as to this threshold and filing deadline. Privately optimal, socially wasteful financial engineering seeking to take advantage of regulatory arbitrage opportunities would be deterred.

Third, the partial harmonization would significantly ease reporting burdens on market participants. Simply having uniform filing deadlines and thresholds would reduce compliance costs. In addition, the 5-day filing deadline for the proposed Schedule 13D is far more generous than that for the 1-day deadline for the proposed Schedule 10B. Major trade associations have stated that the 1-day filing deadline is 'practically unworkable'.[162] Finally, the Schedule 10B $300 million threshold would trigger far more filings than a 5 per cent threshold.

The main disadvantage to the solution I propose is its possible impact on the fraud and manipulation and financial stability goals of Schedule 10B. However, there are grounds to believe that the impact would be limited.

First, in terms of public information, cash-settled equity swap holdings continue to have to be reported, except that they would be reported not on the basis of a 1-day deadline but instead on the basis of a 5-day deadline. Especially given the low notional amount threshold of $300 million, it is far from clear whether a delay of 4 days with respect to such reporting would have a material impact on the detection of fraud and manipulation or on financial stability.

In contrast, shortening the proposed 5-day Schedule 13D deadline to the proposed 1 day Schedule 10B deadline would significantly disrupt the delicate balance between market transparency and shareholder activism. The social costs in the loss of activism likely outweigh the social benefits as to fraud and manipulation and financial stability.

Similarly, the 4-day difference may materially affect the opportunities for market participants to find the proverbial free lunch (and thereby promote market efficiency), without necessarily helping with respect to fraud and manipulation or financial stability.

Second, the SEC itself will have access to highly granular information. Security-based swap data repositories are required to establish policies and procedures reasonably designed to calculate the outstanding security-based swap positions for all persons for which such depositories maintain data.[163]

III. Empty voting, empty crediting and hidden non-interest: the SEC and other players

A. *Overview*

More public disclosure may be a sufficient response to hidden (morphable) ownership: it would no longer be hidden. The SEC's basic regulatory philosophy since its creation has

162 Ibid 24–25.

163 See C.F.R. § 240.13n-5(b)(2).

been that of disclosure, and its primary task has always been to ensure a robust public informational base. Private ordering based on market incentives has long been viewed as insufficient to generate such an informational base. Delaware has never sought to intrude on this SEC turf in a material way. The SEC's role is unique and exclusive as to hidden (morphable) ownership.

The SEC's roles as to empty voting and empty crediting are different. With respect to empty voting, the SEC's proposed moves could play a material supporting role in helping substantive corporate law authorities identify the kinds of empty voting that may cause them to preclude the exercise of such rights. With respect to empty crediting and hidden non-interest, the SEC can potentially play an important role alongside the role of private ordering. But the SEC's approach has fundamental problems, and I suggest major changes.

Part III.B focuses on empty voting. Part III.C focuses on empty crediting and hidden non-interest.

B. *Empty voting and corporate governance*

1. The SEC proposals and empty voting

At least three families of strategies can address empty voting.[164] One family, the most direct, would focus on the voting rights themselves: when or how should the voting rights be limited? Courts, including the Delaware judiciary, and private ordering have taken strong steps to directly curb empty voting. A second family would involve modifying the mechanics of shareholder voting and related exercises of shareholder power. The Delaware legislature has modified the statutory record date provisions and private ordering has, to the extent permitted by courts, modified advance notice bylaws, the right to call special meetings, and poison pills. A third family, the most indirect and incremental, would modify supply and demand factors in the market for empty voting. I discuss substantive law authorities (such as the Delaware judiciary and legislature) in Part III.B.2 and private ordering in Part III.B.3.

The SEC's pertinent releases, in effect, adopted the third, most incremental family of strategies: influencing the supply and demand factors in empty voting. At first glance, the most pertinent of these releases are the September 2021 Release on proxy voting disclosure (Proxy Voting Release), the November 2021 Release on share lending (Share Lending Release), and the February 2022 Release on short selling (Short Selling Release).[165] Empty voting sometimes relies on share lending and short selling. And the institutional investors that are subject to proxy voting disclosure often lend out their shares.

The SEC used empty voting as a justification only in the Proxy Voting Release.[166] That Release is also the only one of these three releases that would generate any publicly available information.

164 Hu and Black, 'Decoupling II (Penn)' (n 2) 696–97 (associated Sections B, C, and D).

165 See (n 9).

166 See Proxy Voting Release (n 9) 57,484, 57,503 n.228.

The Proxy Voting Release would require institutional investment managers like mutual funds, most exchange-traded funds, and certain other investment companies to provide more information in the annual disclosures they make about their proxy voting records.[167] Currently, these funds are not required to disclose the number of shares that they had lent and did not recall—and thus could not vote. The Proxy Voting Release would require that the fund not only disclose the number of shares they voted, but also the number of shares that had been lent and were not recalled.[168] The SEC's justification for this enhanced disclosure was explicitly grounded in part over concerns about how empty voting through share borrowings could lead to voting that is against the interests of fund investors.[169]

With the Short Selling Release, the SEC's stated goals are to provide greater transparency in the short selling market, which could among other things, promote greater risk management among market participants, and bolster confidence in the markets.[170] With the Share Lending Release, the SEC's stated goals were to increase transparency and efficiency of the securities lending market by requiring any person that loans a security to report certain material terms to a registered national securities association.[171]

The information generated under these two Releases that would be made public was limited. The Short Selling Release did not require public disclosure of any individual participant's short positions or related trading activity. Instead, the SEC would publish only anonymous aggregated short-position data for each security and related trading information on a delayed basis.[172] Similarly, the Share Lending Release does not require public disclosure of the identity of the customer borrowing the security.[173]

However, a closer examination of current SEC Releases suggests that the SEC can play a material secondary role as to empty voting. This is because, notwithstanding the absence of a public disclosure requirement in the proposed Short Selling Release, the SEC is not wholly solicitous of market participants who seek to profit from share price declines and, for economic, reputational and other reasons, wish to remain anonymous. A market participant can profit from share price declines not only by selling short but by using derivatives, such as by purchasing CDS protection or buying certain equity derivatives. Schedule 10B as proposed in the Swaps Release requires public disclosures of certain CDS holdings and certain equity derivatives holdings, as described in Part III.C below and Part II.B above, respectively.

A market participant considering the potential benefits of becoming an empty voter with a negative economic interest may be deterred from doing so if the Schedule 10B

167 Ibid 57,479–80.

168 Ibid 57,489.

169 Ibid 57,503 (citing, among other things, Hu and Black, 'Decoupling II (Penn)' (n 2).

170 Short Selling Release (n 9) 14,951.

171 Share Lending Release (n 9) 69,802, 69,804.

172 See Short Selling Release (n 9) 14,955.

173 However, there is legitimate concern that other information that the SEC would mandate be publicly disclosed is sufficiently granular that sophisticated observers may be able to identify the borrower and its short positions. Presumably, the SEC may modify this aspect of the Share Lending Release to conform with the Short Selling Release's approach.

disclosures cause such a status to come to light. And if a market participant decides to go ahead despite such public exposure (and the ensuing reputational and other effects), as we shall next see, there is a serious possibility that judges in Delaware and elsewhere may reject the participant's ability to actually exercise its voting rights.

2. Delaware courts and other substantive corporate law authorities and the contributing role of the SEC

Substantive law-centred authorities such as judges and state legislators are increasingly addressing empty voting issues. For instance, the Delaware legislature and courts have shown concern over empty voting, sometimes explicitly using the analytical framework for decoupling.

On 1 August 2009, what are sometimes referred to as the 'empty voting amendments' to the Delaware General Corporation Law came into effect.[174] Section 213(a) was amended to, among other things, allow corporations to fix a record date for determining stockholders entitled to vote that is different from the record date for notice of a stockholder meeting.[175] The basic concept was to allow the corporation to move the record date for voting purposes closer to the meeting date so the corporation could reduce the chances of voting by persons who no longer had an economic interest in the company.[176] The Delaware Supreme Court characterized these amendments as 'guarding against the decoupling of economic ownership from voting power'.[177]

Delaware courts have also been receptive to the analytical framework for decoupling as a general matter, most clearly seen in the 2010 Delaware Supreme Court case of *Crown EMAK*.[178] *Crown EMAK* dealt with the issue of whether the third-party vote-buying agreement at issue would be permitted. In concluding that the votes were proper, Chief Justice Steele explicitly did so on the grounds that 'the economic interests and the voting interests of the shares remained aligned'.[179] The opinion set out in full and explicitly relied on three core definitions in the analytical framework: 'economic ownership', 'full ownership' and 'formal voting rights'.[180]

174 See, eg, Potter Anderson & Corroon LLP, An M&A Lawyer's Guide to the DGCL Amendments (2009), <https://www.potteranderson.com/newsroom-publications-46.html>.

175 Corporations—General Corporation Law—Proxies, An Act to Amend Title 8 of the Delaware Code Relating to the General Corporation Law, H.B. 19, 145th Gen Assembly, Delaware Laws Ch 14 (2009).

176 Del Code Ann tit 8, § 213.

177 See *Crown EMAK Partners, LLC v Kurz*, 992 A.2d 377, 402, n.7 (Del 2010).

178 992 A.2d 377 (Del 2010). The lower court decision in Chancery relied heavily on the empty voting framework in analysing the vote buying agreements. See *Kurz v Holbrook*, 989 A.2d 140, 177 (Del Ch), judgment entered (Del Ch 2010), and aff'd in part, rev'd in part sub nom. Crown EMAK Partners, *LLC v Kurz*, 992 A.2d 377 (Del. 2010) ('recent scholarship has cast light on shadowy aspects of the voting process and techniques by which voting rights can be manipulated'). Vice Chancellor Laster cited Hu and Black, 'Decoupling I (Finance)' and Hu and Black, 'Decoupling II (Penn)' (n 2) in *Kurz*, 984 A.2d at 184, n.19.

179 *Crown EMAK*, 992 A.3d at 390.

180 Ibid 390–91 (relying on definitions set out in Hu, 'Innovation and Governance (n 2); earlier in the opinion, the court cited Hu and Black, 'Decoupling I (Business Lawyer)' (n 1) , and Hu and Black, 'Decoupling II (Penn)' (n 2). Theodore Mirvis of Wachtell, Lipton, Rosen & Katz characterized this case as having 'endorsed recent scholarship by Professors Henry Hu and Bernard Black on what they have called "empty voting," and the danger to corporate policy presented by the [decoupling] of voting interests and economic interests'. See Theodore Mirvis, 'Delaware Address Vote Buying and Synthetic Ownership', Harvard Law School Forum on

These decoupling concepts have flowed through different areas of Delaware law.[181] Then-Vice Chancellor Strine, who had engaged with the analytical framework in a prior case,[182] discussed the relationship of irrevocable proxies and empty voting in *TR Investors.*[183] He viewed with scepticism voting by persons with a 'relatively small economic interest', as well as voting by investors with an economic interest adverse to the firm who could vote in ways that reduce the company's share price.[184] Strine held that irrevocable proxies needed to be stringently interpreted to help avoid the empty voting problem in the face of the 'important [empty voting] public policy concerns' that *Crown EMAK* 'underscored'.[185]

This year, Vice Chancellor Laster's opinion in *Hawkins v Daniels*[186] dealt with whether an irrevocable proxy arrangement ran with the sale of a corporation's majority shares.[187] Vice Chancellor Laster starts his opinion by discussing the risk of divergent economic interests and how Delaware irrevocable proxy law is designed to 'reunite' voting rights with economic interests.[188] In holding that the irrevocable proxy did not run with the proxy, he intertwined the logic associated with the empty voting analysis and Delaware proxy law.[189] He stated that '[t]he concerns raised by decoupling voting power from ownership have implications for how a court applying Delaware law interprets a proxy arrangement'.[190] '[A] proxy arrangement . . . decouples the power to vote the shares from the economic interest in the shares'.[191] '[I]f the proxy holder has divergent interests, then the resulting non-terminable separation of ownership becomes mischievous'.[192] As Strine did in *TR Investors*,[193] Laster cited the proposition in the 2010 Delaware Supreme Court opinion in *Crown EMAK* that 'for many years, Delaware decisions have expressed consistent concerns about transactions that create a misalignment between the voting interests and the economic interest of shares'.[194]

Corporate Governance & Financial Regulation (3 May 2010), <https://corpgov.law.harvard.edu/2010/05/03/delaware-addresses-vote-buying-and-synthetic-ownership/>.

181 Apart from the cases in the main text, see, eg, *Zohar II 2005-1*, *Ltd v FSAR Holdings*, Inc, 2017 WL 5956877, at *22 (Del Ch 30 November 2017). In *Zohar*, Vice Chancellor Slights' discussion of voting rights in an irrevocable proxy case cited *Crown Emak*'s use of empty voting ('full' stock ownership 'consists of voting ownership plus direct economic ownership').

182 See *Parfi Holding AB v Mirror Image Internet, Inc*, 954 A.2d 911, 940 (Del Ch 2008) (describing the plaintiff in the case as 'empty' for having no 'economic interests in the recovery pursued for the corporation'). Strine discusses the 'empty voting' of corporate shares. See ibid 944, n. 108.

183 2010 WL 2901704, (Del Ch July 23, 2010), *aff'd*, 26 A.3d 180 (Del 2011).

184 Ibid *21.

185 Ibid. Strine opined that 'separating voting control from stock ownership—which can result in "empty voting," where an investor votes stock without having an accompanying economic interest—raises important public policy concern,' citing Hu and Black, 'Decoupling I (Finance)' and Hu and Black, 'Decoupling II (Penn)' (n 2).

186 273 A.3d 792, 795 (Del Ch), *Judgment entered*, (Del Ch 2022).

187 Ibid 796.

188 Ibid 795.

189 Ibid 808–10.

190 Ibid 808.

191 Ibid.

192 Ibid 809.

193 *TR Investors*, 2010 WL 2901704 at *22 n.139.

194 *Hawkins*, 273 A.3d at 809; see also *Crown EMAK*, 992 A.2d at 388.

Empty voting has also come up in cases related to voting arrangements. In 2020, Vice Chancellor Laster cited *2006-Decoupling I (Southern Cal)* to demonstrate how the decoupling of economic interest from voting interest can grant certain investors different incentives than other shareholders in *In re Dell Technologies Inc Class v Stockholders Litigation*.[195]

Moreover, albeit without grounding it in the decoupling framework, Delaware has demanded alignment of economic and voting rights in cases involving majority-of-the-minority conditions. In *CNX Gas*,[196] Vice Chancellor Laster noted how 'economic incentives matter, particularly for the effectiveness of a legitimizing mechanism like a majority-of-the-minority tender condition or a stockholder vote'.[197] Laster relied on clear divergent incentives to reject the deal.[198] A similar situation occurred in *Pure Resources*,[199] where then-Vice Chancellor Strine excluded the holders of shares subject to put agreements from a majority-of-the-minority calculation because 'it [was] clear that the put agreements can create materially different incentives for the holders than if they were simply holders of . . . common stock'.[200]

Outside of Delaware, the most dramatic example of judicial intervention to limit the substantive voting rights of an empty voter occurred in the proxy fight between TELUS Communications (TELUS) and hedge fund Mason Capital Management (Mason Capital), one of the highest profile and most contested proxy fights in Canadian history.[201] Using the analytical framework for decoupling, the Supreme Court of British Columbia's December 2012 opinion explicitly sought to determine whether Mason Capital's idiosyncratic long and short positions in TELUS's two classes of stock resulted in the hedge fund being an empty voter with negative economic ownership.[202] Justice Fitzpatrick, relying in part on the affidavit the author of this article provided, found 'in all likelihood' that Mason Capital was such an extreme form of empty voter and that this status was relevant to the court's consideration of Mason Capital's objections to a recapitalization plan. She approved the plan and, a month later, Mason Capital gave up its fight against TELUS's proposal.

It would be interesting to see how Delaware courts would address a TELUS-type situation. There is ample case law of Delaware courts taking a dim view of empty voters in a variety of contexts. Given the court's apparent antipathy to empty voters in general, they

195 2020 WL 3096748, at *18 (Del Ch June 11, 2020) ('A minority stockholder also may have divergent interests in a transaction, whether economic or otherwise').

196 *In Re* CNX Gas Corp S'holders Litig, 4 A.3d 397 (Del Ch 2010).

197 Ibid 416.

198 Ibid. In *CNX Gas*, CONSOL, an energy company, formed CNX Gas and tried to spin it off. The largest minority shareholder of CNX Gas was T. Rowe Price, beneficially owning 6.3% of the outstanding common stock of CNS Gas. T. Rowe Price also had a 6.5% stake in CONSOL. Ibid 400–1.

199 *In Re* Pure Res, Inc, S'holders Litig, 808 A.2d 421 (Del Ch 2002).

200 Ibid 426.

201 TELUS Corporation (re), 2012 BCSC 1919 (2012) (hereinafter *TELUS Opinion*). The author prepared the affidavit as an expert to assist the court and not as an advocate for any party pursuant to the strict requirements of Rule 11-2(2) of the British Columbia Supreme Court. See Affidavit of Henry TC Hu, TELUS Corporation (RE), 2012 BCSC 1919 (8 October 2012). The legal counsel for TELUS were Norton Rose Canada and Farris Vaughan Willis & Murphy.

202 Ibid.

would most likely exhibit even greater antipathy to empty voters with negative economic ownership. As such, if a *TELUS*-type case were to hit Chancery soon, the result would be likely the same.

The SEC's proposed Schedule 10B can help Delaware as well as the subject companies identify the presence and identity of empty voters, as discussed in Part III.B.1. The granular information made available should help courts and companies identify the extent to which such voters are empty: the ability of empty voters with negative economic ownership to exercise the voting rights attached to the shares they hold would be at risk.

Delaware courts have also considered attempts by private ordering to address morphable ownership, a topic to which we now turn.

3. Private ordering

Corporations have taken a variety of steps to address both empty voting and morphable ownership. Indeed, the emergence of what are referred to as 'second generation' advance notice bylaws and poison pills has been directly attributed to concerns over:

> 'empty voting,' 'morphable' equity ownership,' 'decoupling of economic and voting interests,' 'record date capture' and other uses of derivatives and market mechanics to separate the voting rights of stock ownership from its economic attributes and to divide the attributes of ownership into a bundle of rights and obligations that can be separated . . ..[203]

Advance Notice Bylaws and Special Meetings: Empty Voting and Hidden (Morphable) Ownership. Beginning in early 2008, law firms began recommending that their clients insert certain requirements in their advance notice bylaws.[204] These requirements called for proxy contest proponents to include their required advance notice information concerning their decoupled equity and voting interest, irrespective of whether the synthetic equity carried any voting power.[205] Indeed, these bylaws extended to a wide range of financial products, including options and swaps, as well as broad catch-all phrases that sought to capture any economic interest at all.[206] By a year later, these provisions were inserted in over 550 second-generation advance notice bylaws.[207]

Mere economic ownership alone would trigger disclosure. The district court decision in *CSX* was uppermost in mind. This helped overcome perceived uncertainties as to whether Schedule 13D captured cash-settled equity swaps—ie, the efficacy of the hidden (morphable) ownership strategy.[208]

203 Charles M Nathan, *Second Generation Advance Notice Bylaws and Poison Pills*, *Harvard* Law *School Forum on Corporate Governance* (22 April 2009), <https://corpgov.law.harvard.edu/2009/04/22/second-generation-advance-notice-bylaws-and-poison-pills>.

204 Ibid.

205 Ibid.

206 Mark Weingarten and Erin Magnor, *Second Generation Advance Notice Bylaws*, *Harvard* Law *School Forum on Corporate Governance* (17 March 2009), <https://corpgov.law.harvard.edu/2009/03/17/second-generation-advance-notification-bylaws>.

207 Nathan (n 203).

208 Weingarten and Magnor (n 206).

Empty voting in connection with shareholder calls for special meetings of shareholders has also been dealt with by some companies. A recent example illustrates this in stark form.

On 29 July 2022, Booz Allen Hamilton Holding Corporation revised its bylaws so that in order to call a special meeting the stockholder must have 25 per cent of the common stock and, more interestingly, added provisions on how that 25 per cent would be calculated. In determining whether the 25 per cent threshold is met, the shareholder must have both full voting rights in the shares and full economic interest in those shares.[209] In other words, a 25 per cent shareholder that is an empty voter cannot call such a meeting.

Poison Pills: Morphable Ownership and Hidden (Morphable) Ownership. Companies have also provided that synthetic ownership be included in the definition of beneficial ownership in shareholder rights plans, typically referred to as poison pills. On the substantive side, this flowed in part from a belief in the morphability of synthetic ownership, and it being the functional equivalent of traditional equity ownership.[210] On the disclosure side, there was concern that companies were using the hidden (morphable) ownership strategy to accumulate stock positions under the radar in excess of the trigger threshold.[211]

Today, the inclusion of synthetic ownership in the disclosure trigger is widespread, but plans vary in determining what kinds of synthetic ownership count. Every traditional shareholder rights plan adopted in March 2020 included derivatives in the trigger.[212] In determining what kinds of synthetic ownership count, some companies use the broad definition of 'derivative securities' set out under Rule 16a-1.[213]

Delaware courts have considered inclusion of synthetic equity in poison pill triggers. The 2009 *In re Atmel Corp Shareholders Litigation* case centred on an amendment to an Atmel poison pill that expanded the definition of 'beneficial ownership' to encompass derivative securities that provided economic benefits and risks corresponding to ownership of Atmel common shares.[214] The express intent of the expanded definition was to address morphable ownership. Counsel for Atmel contended that, absent the change, a takeover bidder could, without exceeding triggering thresholds, obtain the shares by closing out its derivative position. Counsel referred to the decoupling analytical framework in general, the hidden (morphable) ownership component in particular, and the *CSX* hidden (morphable) ownership opinion.

209 Booz Allen Hamilton Holding Co, Report of unscheduled material events or corporate event (Form 8-K), (2 August 2022) <https://investors.boozallen.com/sec-filings/sec-filing/8-k/0001443646-22-000139>; Booz Allen Hamilton Holding Corporation, *Sixth Amended and Restated Bylaws As Adopted on July 29, 2022*, <https://investors.boozallen.com/static-files/fb5fd081-e8f8-4c7e-a567-8af5d91b7f6e>.

210 Nathan (n 203).

211 Sanjay M Shirodkar and others, *The Rise of the Aggressive Poison Pill*, Harvard Law School Forum on Corporate Governance (24 April 2020), <https://corpgov.law.harvard.edu/2020/04/24/the-rise-of-the-aggressive-poison-pill>.

212 Ibid.

213 Westlaw Practicing Law Corporate & Securities, Innovations in Poison Pill Drafting, Thomas Reuters Practical Law (2022).

214 Transcript of Oral Argument, In re Atmel Corp. S'holders Litig, No 4161-CC (Del Ch 22 May 2009). The author was retained as a consultant in this connection by Wachtell, Lipton, Rosen & Katz, counsel to Atmel.

Ruling from the bench, Chancellor Chandler rejected the plaintiff's request for a preliminary injunction, primarily on procedural grounds. Although the ruling did not deal with the substantive issue of the validity of the expanded definition, the Chancellor noted the strategy in detail and referred to the 'complex and novel issues' involved and the need for 'careful, reasoned, and incremental response of the law to the ever-changing practices that affect Delaware corporations'. The parties reached a settlement a few months later involving some definitional clarifications.

In 2021, then-Vice Chancellor McCormick enjoined The Williams Companies, Inc from continued operation of a poison pill that Williams had adopted in response to a plummeting stock price at the height of the Covid crisis.[215] In determining the pill's validity, the Court analysed, among other things, whether the defensive measure was reasonable in relation to the threat posed. Based on four key terms of the pill considered as a whole, the Court found the plan was not proportional. One such term was the pill's definition of 'beneficial ownership', which included cash-settled derivatives. The Court criticized this definition, finding it to be 'extreme'. However, the term that she found to be the 'primary offender' was an extremely broad acting in concert provision. It is not clear from the opinion what definition of 'beneficial ownership' would not be problematic in her view. The Delaware Supreme Court Order two-sentence affirmance did not offer fuller guidance.[216]

C. Empty crediting, hidden non-interest and debt governance

1. The key empty crediting concern: perverse incentives in tandem with control rights

Empty crediting, like the CDSs typically utilized by creditors in empty crediting, has private and social benefits. As discussed in Part I.C, this is so even though debt governance can be more complex, especially if the borrower is unaware that his creditor has hedged away some or all of its exposure.[217] Because regulatory burdens will likely curtail empty crediting and the use of CDSs, the private and social costs this would entail need to be considered in SEC rulemaking.

Currently, there is a scarcity of public information as to the presence of empty creditors and related matters.[218] This scarcity undermines the informational base needed by investors, the capital markets, and troubled corporations themselves. It also contributes to abuses in the CDS market, including 'manufactured' defaults addressed by the SEC's proposed Rule 9j-1 (to be discussed in Part III.C.2). How the new Schedule 10B's CDS disclosure requirements can ensure a more robust informational base is among the requirements' key benefits.

One empty crediting situation, however, is deeply troubling on both private and social grounds. That is the situation of empty creditors with a negative economic interest,

215 Williams Cos S'holder Litig, 2021 WL 754593 (Del Ch 26 February 2021), *Judgment entered sub nom.*

216 *Williams Cos., Inc v Wolosky*, 264 A.3d 641 (Del 2021).

217 Complexities arise even if an empty creditor is not an empty creditor with a negative economic interest. See, eg, Hu, *Empty Creditors and GFC* (n 10); Hu, 'Innovation and Governance' (n 2) 370–71; Hu, 'CDS Decoupling & Abuses' (n 2) 20.

218 See, eg, Hu, 'CDS Decoupling & Abuses' (n 2) 17–21.

something that will be illustrated in the *Windstream* discussion forthwith. Here, allegedly, the perverse incentives of the creditor in tandem with the control rights from the bond indenture is at the root of the story.

Any SEC effort to address empty crediting must address the one situation where empty crediting is almost certainly privately and socially destructive. As Part III.C.2 shows, the SEC's effort directed explicitly at net short creditors ignores the essential link between perverse incentives and control rights. I propose major changes. Part III.C.3 shows that private ordering increasingly addresses such extreme empty creditors, but private ordering is insufficient, and that the SEC can play a vital role in filling the gap.

A possible illustration of the effects of an empty creditor with negative economic interest occurred on 25 February 2019, when Windstream, a telecom company, filed for bankruptcy.[219] This was after an extended court battle between it and hedge fund Aurelius Capital Management. In 2017, Aurelius, a Windstream creditor, sent a notice of default stating that, 2 years earlier, Windstream had breached certain bond covenants. No other creditor had complained of this. Litigation resulted involving multiple matters. On February 15, the judge found for Aurelius in all respects, and awarded it $310 million. The next trading day, Windstream's stock fell about two-thirds, and on February 25, Windstream filed for bankruptcy.

Why did Aurelius undertake an action that might cause its borrower to go bankrupt? Windstream argued—no one really knows for sure because Aurelius never disclosed its CDS position—that Aurelius had a large CDS position relative to the debt it held.

Assuming Windstream was correct, notice that if Aurelius merely had an outsized CDS position, it could not have caused the bankruptcy. It is the fact that the perverse incentives flowing from the CDS holdings combined with the control rights Aurelius had to call a default that could cause the bankruptcy.

2. The SEC's proposed approach and a proposed modification

The Swaps Release represents the SEC's primary effort to address concerns over the use of CDSs, including for the purpose of empty crediting. The effort relies on two primary mechanisms. The first is a new rule, Rule 9j-1, framed to prevent fraud, manipulation and deception in connection with effecting transactions in, or inducing or attempting to induce, the purchase or sale of any security-based swap.[220]

As to Rule 9j-1, the SEC had in mind abusive games associated with the CDS documentation, such as attempts to 'manufacture' defaults that, as a technical matter, would trigger payouts under a CDS or to influence the timing of defaults.[221] The intentional default by homebuilder Hovnanian on an interest payment as part of a deal with Blackrock's GSO arm, which had bought CDS protection on the company is an example.[222] In return for

219 This discussion draws in part from Hu, 'CDS Decoupling & Abuses' (n 2) 27–31; Hu, *Reform the CDS Market* (n 10).

220 Swaps Release (n 8) 6,654–56.

221 Hu, 'CDS Decoupling & Abuses' (n 2) 17–31.

222 Ibid 26–27.

Hovnanian missing a payment that would have triggered a payout on the CDS, GSO helped Hovnanian refinance up to $320 million of its debt at a favourable interest rate. After a CDS seller sued, the manufactured default was called off.

The SEC emphasized that Rule 9j-1 covers only circumstances in which the CDS payment is 'intentionally distorted'. Rule 9j-1 likely does not cover the empty creditor with negative economic interest situation. Because Rule 9j-1 does not cover this situation and, more broadly, because intentional distortions by themselves do not constitute decoupling, I do not address either the Rule or such distortions in this article.

It is the CDS-related aspects of the other operative mechanism—the proposed Schedule 10B disclosure of security-based swap positions (such as CDS positions)—that is pertinent to empty creditors. Indeed, one key justification that the SEC offered for such CDS disclosures was the empty creditors with negative economic interest situation, including a media story on Windstream.[223]

Schedule 10B is generally required to be filed by anyone with a CDS position that is in excess of any of three possible thresholds.[224] One threshold is met when, roughly speaking, the amount of CDS protection a holder has exceeds the amount of debt it holds by $150 million or more. In such event, the SEC felt:

> a CDS counterparty may be incentivized to act against their own interest as a debt holder (i.e., because they stand more to gain from their CDS than they would lose on their bonds) . . . .[225]

However, a closer look at the three thresholds suggests that the fit between Schedule 10B's net short creditor aspirations and Schedule 10-B's basic operative mechanism is far looser than the foregoing may suggest. The proposed Rule 10B-1(1)(i) provides that the threshold with respect to CDSs is the lesser of:

> (i) A long notional amount of $150 million, calculated by subtracting the notional amount of any long positions in a deliverable debt security underlying a security-based swap included in the security-based swap position from the long notional amount of the security-based swap position; (ii) a short notional amount of $150 million; or (iii) a gross notional amount of $300 million.[226]

Clause (iii) means that the threshold can be triggered even when the market participant holds no debt or equity whatsoever, and thus has none of the control rights that flow from such debt or equity holdings. For instance, anyone who simply holds a notional amount of $300,000,000 of CDSs calculated on a gross basis would be required to file. Such a person with CDS-only positions are not even creditors, much less empty creditors of any kind.

But concerns over empty creditors of any type exist only if, in addition to troublesome incentives flowing from CDS position, the holder of CDS also has control rights. A person who holds the long side of a CDS can merely hope the referenced company goes bankrupt or otherwise deteriorates in creditworthiness. It is the possession of the control rights

223 Swaps Release (n 8) 6,656, 6,667 n.111 (citing two academic articles on debt decoupling).

224 Ibid 6,670.

225 Ibid 6,670.

226 Ibid 6,704.

flowing from holdings of debt or equity that gives that person the sword to destroy that company.

The result is that the burdensome Schedule 10B filings would often have to be made in circumstances where no empty crediting or hidden-non-interest issues are possible even in theory. It is Schedule 10B's other CDS-related goals that have largely determined the Schedule 10B's CDS disclosure requirements. As discussed in Part II.B, Schedule 10B was primarily directed at CDS-related fraud and manipulation and the systemic risks associated with hidden concentrations of CDS exposures for financial institutions.

Apart from Schedule 10B imposing reporting burdens on persons with no control rights whatsoever, it also imposes burdens irrespective of the extent—or even the direction—of their incentives. The $300 million notional amount threshold applies irrespective of whether that position represents a long position or a short position. But persons with long CDS positions have precisely the opposite incentives of persons with short CDS positions—one group wants to see the company fail while the other group wants the company to thrive. Yet both have to report.

Moreover, the threshold is considered a gross basis, not a net basis, and is based on a one-size-fits-all notional amount trigger. Conceivably, a person that has roughly equal long and short positions, and thus almost no incentives with respect to the company's fortunes, would have to report. The use of a one-size-fits-all trigger of $300,000,000 may be difficult to justify when the subject company is large and has many billions of debt outstanding.

Thus, a CBA justification of the CDS-related provisions of Schedule 10B would have to rest on the non-decoupling related goals of Schedule 10B, such as those relating to financial stability. I have recognized how CDSs and empty crediting can indeed affect financial stability.[227] It is beyond the scope of this article to address the merits of Schedule 10B with respect to these non-decoupling related goals.

What is within the scope of this article is the real prospect of a successful CBA-based court challenge to Schedule 10B. Indeed, the SEC itself appears to recognize this. In the Beneficial Ownership Release, the SEC requested comment on the implications for the proposed Schedule 13D/13G regime 'if the information regarding cash-settled equity swaps that would be required pursuant to proposed Rule 10B-1 were not available'.[228]

From the standpoint of having the SEC address empty crediting and hidden non-interest matters, a backup plan is necessary in the event of a successful court challenge. A more focused approach, one tailored to decoupling, should be simpler and less burdensome than the Schedule 10B proposed by the SEC and easier to justify.

The most common situation of empty creditors is that of emptor creditors who do not have a negative economic interest. As noted in Parts I.C and III.C.1, public information on such typical empty creditors would be useful on a variety of private and public grounds.

227 See, eg, Hu and Black, 'Decoupling II (EFM)' (n 2) 690–93; Hu, *Empty Creditors and the Crisis* (n 10); Hu, 'Innovation and Governance' (n 2) 370–72.

228 Beneficial Ownership Release (n 8) 13,865.

However, information is particularly valuable to the borrower and to market participants generally if the creditor has a negative economic interest. The SEC's approach to CDS disclosure must address this situation.

With the foregoing considerations in mind, several fundamental changes to the SEC proposal are key. The first fundamental change relates to how Schedule 10B can be triggered simply through holding CDSs. Empty crediting and hidden non-interest concerns can arise only when CDSs are held in tandem with the control rights that flow from holding debt or equity.

No filings should be required unless a person possesses both CDSs and debt or equity securities. Threshold amounts would have to be specified. Greater holdings of CDS may result in greater incentives from the CDS payoffs. Greater holdings of debt or equity would typically result in greater control rights. The sizes of the incentives and of the control rights each matter.

Second, troublesome incentives need to exist. Holders of CDS positions that would cause them to want a company to thrive should not be subject to burdensome reporting. Along the same lines, consideration should be given to thresholds being calculated on a net basis, not on a gross basis. It is the net basis that gives direction to the holder's incentives.

Third, to the extent that troublesome incentives exist, they should be in an amount that would be material to the fortunes of the company. The use of a threshold denominated in one-size-fits-all notional amount terms may trigger many filings involving large companies whose outstanding debt dwarfs the proposed $300,000,000 flat amount.

Fourth, the perfect cannot be the enemy of the good. Determining with precision whether a creditor is net short and the size of the net short position can be daunting and too burdensome. For instance, many large public companies have multiple classes of debt. These different classes of debt react differently to changes in the creditworthiness of the company, so merely adding the principal amounts of the classes of debt with disparate characteristics is too simplistic.[229] The architecture of the thresholds cannot be too complex. It only need be accurate enough. In this respect, the 'net short' definitions found in an increasing number of debt agreements—to which we turn next—may be worth examining.

3. Private ordering and the vital role of the SEC

In 2008, a co-author and I wrote that '[n]otwithstanding the complexities in measuring economic ownership, we can imagine the emergence of covenants which limit control rights for creditors who hold zero or negative economic interests'.[230] In spring 2019, following Windstream, so-called 'net short' provisions began appearing in credit agreements.[231]

229 See, eg, Hu and Black, 'Decoupling II (EFM)' (n 2) 683–86.

230 Ibid 686.

231 Todd Keretzky, 'Anti-net Short Provisions in Syndicated Credit Facilities' *Allen & Overy*, at 1 (3 September 2019), <https://www.allenovery.com/en-gb/global/news-and-insights/publications/anti-net-short-provisions-in-syndicated-credit-facilities>; Joshua

These provisions vary widely. For instance, they may require that if the creditor is 'net short' (as defined in the debt agreement), the creditor would be deprived of various control rights, such as the right to vote on amendments on the credit agreement. Some measures have in mind the time gap between the alleged default and Aurelius raising the issue. They require that any default notice be made within a short period of time, such as 2 years. These net short provisions have appeared both in loan documentation and in bond indentures.

Such private ordering is insufficient. One reason is that the benefits from any one borrower contracting for net short provisions extend well beyond the benefits for that borrower. The traditional (unhedged) creditors of the borrower, the sellers of CDS protection, and others would benefit from inclusion of such provisions and not have to pay anything for them. The borrower's inability to capture such significant positive externalities would result in the borrower not investing enough in structuring and bargaining for such provisions from a social standpoint.

What exacerbates this externalities problem is that the investments can be costly. Such net short positions are still evolving, vary widely, and legal uncertainties abound.

Another reason private ordering is insufficient is because private ordering would only work with respect to new debt or debt that the creditor is willing to renegotiate. Most existing corporate debt was incurred before Windstream, and the associated bond indentures or credit agreements entered into would not have any net short provisions. Currently, even the debtor corporation itself, much less investors, may have to rely on hearsay as to the possible presence of extreme empty creditors. Windstream did not even know for sure whether Aurelius fell into this category. As discussed earlier, such information would be helpful to borrowers even in the more typical case of empty creditors who do not have a negative economic interest.

Addressing informational asymmetries as to the presence of empty creditors would not only promote market efficiency but also be in the interests of corporate borrowers, investors, traditional creditors and CDS sellers. The case for an important SEC role in addressing such informational asymmetries is a strong one.

Some of the core reasons in this debt decoupling context correspond to the reasons offered for SEC mandatory disclosure requirements generally. The information generated would be free and widely available to all market participants, would be updated on a continuous basis, would be in a standardized format facilitating cross-creditor comparisons and, given the securities fraud regime, would likely be generally accurate and complete. Persons having to comply with the SEC mandate can offer information in a single standardized format.

Louis Brandeis' classic rationale for SEC disclosure—'sunlight is the best disinfectant'—also applies in the debt decoupling context. Knowing that one's status as an empty

A Feltman, Emil A Kleinhaus, and John R Sobolewski, *Debt Default Activism: After Windstream, the Winds of Change*, Harvard Law School Forum on Corporate Governance (18 June 2019), (harvard.edu) <https://corpgov.law.harvard.edu/2019/06/18/debt-default-activism-after-windstream-the-winds-of-change/>.

creditor with negative economic interest would have to be disclosed would deter some from becoming one. The costs in terms of reputation and general goodwill would be magnified.

There is also at least one reason specific to debt decoupling. Judges can also rein in empty creditors with negative economic interest, just as they have started to with empty voters with negative economic ownership. Given what the Delaware courts have already done in relationship to equity decoupling, it is certainly conceivable that they will follow the Supreme Court of British Columbia into the debt decoupling realm.[232] But this can occur only if the borrowers are aware of the empty crediting status of their lenders and bring it to the attention of the judges.

Conclusion

The impact of decoupling on the core market-based and legal mechanisms of corporate and debt governance is profound. The SEC has long recognized the phenomenon and is now moving forcefully to address certain key aspects of decoupling. The prospective role that the SEC will be playing is a vital one, especially in the area of disclosure. The SEC's foreign counterparts are already addressing this phenomenon, and private ordering as well as judges and legislators responsible for substantive corporate law are also already playing important roles.

Although it is encouraging that the SEC is on the move, fundamental changes to two core aspects of the proposals are advisable. And there is a pressing need for a more robust justification for SEC rulemaking of any kind with respect to one of these aspects.

On the equity decoupling side, the SEC proposes extending the public reporting of large direct equity holdings to include certain synthetic equity holdings. One essential reason for this is to deter the hidden (morphable) ownership strategy, the use of such synthetic holdings to avoid the public disclosures that Section 13(d) mandates in the market for corporate control.

The SEC's proposed regulatory architecture for disclosure of such holdings is byzantine, consisting of two regimes dedicated to different ends and using widely divergent means. It situates the key technique in the strategy in the 'wrong' regime. The article shows that, as a result, the proposed architecture fails to properly address hidden (morphable) ownership, deeply undermines corporate governance and creates startling regulatory asymmetries. I offer an alternative approach.

SEC rulemaking addressing the hidden (morphable) ownership phenomenon by any means is subject to an existential challenge. Some believe that this is a non-problem, that market participants do not use such synthetic equity to game Section 13(d)-type disclosure requirements. I illustrate two promising avenues for the SEC to pursue. First, I show how US-related court findings could be useful by looking at two such cases. Second, I show that

232 See Hu, *Reform the CDS Market* (n 10).

all 10 foreign jurisdictions examined have extended their blockholder disclosure laws to cover such synthetic equity holdings.

On the debt decoupling side, one essential reason for the SEC's CDS disclosure proposals is to help address the empty creditor with a negative economic interest problem. In *Moonraker*, a lesser Bond movie, Hugo Drax says to an aide, '[l]ook after Mr. Bond. See that some harm comes to him'. Similarly, such a net short creditor has both the incentives flowing from its CDS positions to see that its borrower suffers harm, and through its control rights from the debt agreement, it also has the power to do so.

The SEC's proposed CDS disclosure ignores the necessary conjunction of troublesome incentives from CDS holdings with the power from the debt agreement by mandating disclosures in cases where empty crediting is impossible even in theory. Moreover, other aspects of the CDS-related proposals result even in holders of CDS positions who have every incentive to see the company thrive with burdensome disclosure requirements. I propose fundamental changes to the SEC's approach to CDS disclosures.

While private ordering has started to address empty crediting, I show that, for externalities and other reasons, it alone cannot be a sufficient answer. I show the essential role that the SEC can play, and offer an alternative to the SEC's proposed approach.

On the empty voting side, I show that the Delaware judiciary and other substantive corporate law authorities, as well as private ordering, have made important strides. Here, the SEC can play an important supporting role through helping such authorities and private ordering identify the presence of empty voting.

Properly addressing the decoupling phenomenon is a difficult task. The issues are complex: corporate governance, investor protection, market transparency, financial stability and other considerations can run in different directions. The techniques used for decoupling are constantly evolving, and often in ways opaque to outside observers. The SEC is starting to move towards the role that it can and must play. I am confident that the SEC is up to the task.