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**European Securities Market Expert Group**

**Opinion on**

**Disaggregation of Shareholdings**

The European Securities Markets Expert Group (ESME) provides legal and economic advice to the European Commission on the application of the EU securities Directive. ESME was created by Commission Decision 2006/288/Ec of 30 March 2006 (OJ L 106, 19.4.2006, p.14). The list of ESME members is available at:

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### **Disaggregation of Shareholdings**

#### **Background**

Where an investment management business<sup>1</sup> is part of a wider group of companies carrying on other business activities (such as broker-dealer business or investment banking), the investment management business will typically be separated from the other parts of the group by information barriers and other techniques. These techniques assist the group in managing the potential conflicts between the interests of the investment management clients and the interests of the clients of other group businesses (and the group's own interests). In particular, they aim to ensure that the investment management business makes its investment and voting decisions separately and without regard to the interests of other parts of the group.

Similarly, an investment management business may be organised so that different subsidiaries run entirely separate investment management business lines. For example, one subsidiary may run an institutional fund management business, another a mutual fund family. In these circumstances, the businesses may see benefits to separating the research and investment and voting decision-making functions of the different business lines to encourage diversity of investment conviction and holdings. This separation may be reinforced by information barriers between the business lines as a way of managing the potential conflicts of interest between the investment clients of the respective business lines.

In other cases the investment management activity is conducted not in a separate subsidiary but as a division within a single legal entity, such as a bank, even if the division operates on a fully separate basis.

This paper considers the treatment of investment management businesses under certain Directives which can have the effect of requiring holdings controlled by an investment manager to be aggregated with other holdings within the group. The purpose is to examine if these requirements are consistent, to consider if any inconsistencies are justifiable and to consider how they impact on the interests of investment management clients, bearing in mind practical concerns raised with ESME.

#### **EU directives take inconsistent approach to "disaggregation"**

EU directives impose a number of requirements for reporting shareholding positions and imposing shareholding limits (such as takeover or approval thresholds) which require a group of companies to aggregate the shares or voting rights held or controlled by the companies within the group for the purposes of complying with the requirements. However, a requirement to aggregate the shareholdings controlled by an investment management business with the shareholdings held or controlled by other separate business lines (or by separate investment management businesses) would ignore the business reality of internal separation, exacerbate conflicts of interest and can have effects on the behaviour of groups that run contrary to the interests of investment management clients.

Accordingly, in some cases, rules allow groups of companies to "disaggregate" the shareholdings of investment management businesses when complying with relevant reporting thresholds or limits. In effect, "disaggregation" recognises the business reality of separation and

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<sup>1</sup> In this paper, references to investment management businesses are to businesses carrying on discretionary investment management of client portfolios or for investment funds.

treats the relevant investment management business as if it were an entirely separate business for the purpose of compliance with the relevant requirements.

Nevertheless, EU directives are inconsistent in their approach to disaggregation. In particular:

- The Transparency Directive,<sup>2</sup> which regulates disclosure of major shareholdings in EU listed companies, broadly recognises the principle of disaggregation for both EU investment management businesses and non-EU investment management businesses subject to equivalent regulation. See the provisions set out in Annex I which prescribe the conditions for disaggregation.
- However, the recently adopted Prudential Assessment Directive,<sup>3</sup> which regulates when approval is required for the acquisition of a qualifying holding in a bank, insurance company or investment firm, only expressly allows disaggregation of the shareholdings of an EU investment management business and is silent as regards those of a non-EU investment management business even if subject to equivalent regulation.<sup>4</sup>
- In contrast, the Takeover Directive<sup>5</sup> does not expressly deal with disaggregation. However, it requires Member States to impose rules requiring a person to make a takeover bid where it and the persons acting in concert with it acquire shareholdings which give a specified percentage of the voting rights of the target company.<sup>6</sup> The directive also includes provisions that deem members of a group of companies to be acting in concert with one another for these purposes.<sup>7</sup>

It is probably difficult to say that the Takeover Directive requires Member States either to aggregate or disaggregate shareholdings controlled by fund management subsidiaries. Article 5 of the Takeovers Directive refers to a person "holding" securities and the aggregation of the "holdings" of those acting in concert with them. Some Member States may take the view that the Takeovers Directive only requires an acquiror to aggregate shares beneficially owned/acquired by a controlled undertaking. After all, it would be odd if the Takeovers Directive required the aggregation of shareholdings held by a subsidiary which is merely a custodian/nominee of the securities. In addition, in many cases, the fund management company is not even the holder of the shares under management but merely has control of the voting rights under the management agreement.

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<sup>2</sup> 2004/109/EC, as implemented by the Transparency Implementing Directive 2007/14/EC.

<sup>3</sup> 2007/44/EC.

<sup>4</sup> See e.g. article 3(1) of the Prudential Assessment Directive amending the definition of "qualifying holding" in article 4(1)(27) of the recast Banking Consolidation Directive 2006/48/EC, which applies the provisions of articles 9 and 10 of the Transparency Directive in calculating a qualifying holding, "taking into account the conditions regarding aggregation ... laid down in Article 12(4) and (5) of th[e] [Transparency] Directive". However, this does not refer to the provisions of the Transparency Directive dealing with non-EU investment managers which are contained in article 23 of that Directive.

<sup>5</sup> 2004/25/EC.

<sup>6</sup> Article 5.

<sup>7</sup> Article 2(2) states that persons controlled by another person shall be deemed to be persons acting in concert with that other person and with each other. For these purposes, the definition of control in article 2(1)(f) Transparency Directive applies as a result of article 32 Transparency Directive. It may be that this has to be interpreted with reference also to Article 12 (4) and (5) of the Transparency Directive which would further qualify the definition of controlled undertaking. However even if it does it does not solve the disaggregation issue as Member States can adopt more stringent requirements than the Takeover Directive requires.

Alternatively, even if the Directive might extend the net to cover shares controlled by a fund management subsidiary, it allows a great deal of flexibility to Member States because it allows Member States to determine the "method of calculation" of what constitutes control (articles 2(1)(a) and 5(3)) and/or allows Member States to incorporate derogations in their national rules, so long as those derogations respect the general principles of article 3(1) (article 4(5)(i)).

### **Issues also arise with respect to Member State rules**

The fact that it is unclear how the Takeover Directive addresses these issues may lead to differences of approach across the EU. At least in France<sup>8</sup> and the UK, the rules on takeovers do not allow for disaggregation of shareholdings in a takeover.<sup>9</sup> We doubt that there is power under the Takeover Directive to compel Member States to allow disaggregation. However it would be helpful if the group of non-governmental experts on corporate governance and company law could consider these issues with a view to considering if there is scope for a common approach.

In addition, Member States may have additional rules which raise similar issues. For example, the UK Listing Rules contain provisions regulating transactions between a listed company and one of its substantial shareholders, the definition of which disaggregates the interests held by investment managers under certain conditions.<sup>10</sup>

### **Other issues**

Even the Transparency Directive provisions do not fully resolve all the issues that arise with respect to disaggregation. For example:

- The Transparency Directive provisions do not assist where the investment management activity is conducted not in a separate subsidiary but as a division within a single legal entity, such as a bank, even if the division operates on a fully separate basis.
- They do not assist where the group operates part of its investment management business through an insurance subsidiary, at least if the insurance company manages its own investments.
- The Commission has not used the mechanism to ensure that all Member States take the same approach when deciding which third country regulatory regimes to treat as equivalent for the purposes of the Transparency Directive.

### **Failure to recognise disaggregation potentially harms investor interests**

A takeover or similar regulatory limit, when applied at the group level, can prevent entities within an investment management group from investing fully in line with their own, separately

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<sup>8</sup> Currently, the Takeover regulation is in process of being reviewed; however, no changes are expected concerning the existing rules on disaggregation.

<sup>9</sup> The UK Takeover Panel does allow financial groups to obtain permission to disaggregate positions held by their investment management arms for the purposes of the 1% disclosure rule that applies during the course of a bid (under rule 8.3 of the City Code). However, the Takeover Panel generally does not grant dispensations allowing financial groups to disaggregate their holdings for the purposes of the mandatory bid rule, which applies at 30% and in the 30% to 50% band and requires a mandatory bid where a person or connected group of persons acquires shareholdings in excess of the threshold.

<sup>10</sup> LR11.1

determined investment convictions. One way of resolving the compliance issues is internally to allocate parts of the limit to different parts of the group, but this reduces investment flexibility and is inherently inefficient.

Even a disclosure threshold can have adverse effects as it requires disclosure of information on different positions across the group that would not have been available were they treated as separate legal entities.

Differences in implementation of disclosure standards - and disaggregation rules in particular - also increase compliance costs for large investment management groups investing across many Member States.

These rules primarily impact large investment management groups. Such managers typically introduce capital and increased liquidity into local markets; do not invest for control; will have robust internal procedures to maintain the disaggregation of their separate businesses. Anecdotal evidence suggests that the issues are getting more difficult for some investment management groups as the size of funds under management increases. In addition, where investments are carried out on an indexed basis, the firm has less flexibility to decide how to invest and thresholds and limits become more pressing.

On the other hand, it is clear that there are larger issues involved where a group's aggregate shareholdings in a company exceed a mandatory bid threshold, as these situations raise issues not only about transparency but also about the protection of minority shareholders where control may shift without a mandatory offer being made. There are concerns in this context about risks of abuse and the difficulties for a regulator of assessing compliance with the conditions for disaggregation by groups of companies and detecting cases where, despite information barriers, one member of a group considers that it ought to assist another by supporting an offer or proposal. There may also be concerns about the difficulties of monitoring new classes of investor such as sovereign wealth funds.

### **Investing for control-defining the concept**

If a common approach were developed which would allow disaggregation under the Takeover Directive there would need to be a clear line which would prevent abuse by investment managers who were in fact investing with a view to control. The distinction between influence as a result of a shareholding and control of an entity also needs to be recognised. The question is therefore how would an entity show that it was not investing for control.

- The principles of disaggregation in the Transparency Directive already contain a number of controls which protect against abuse of these provisions by investors seeking to invest for control: (i) entities with a common parent must exercise voting rights independently in order to be disaggregated (Article 12 (4)-(5)); (ii) disaggregation in these circumstances is limited to specified types of investment firms and management companies; (iii) the Directive also requires combined reporting of interests where there is an agreement obliging them to adopt through exercise of their voting rights a "lasting common policy towards the management of the issuer"(Article 10(a)). Moreover, these controls require an investment manager to make significant structural changes and adopt formal policies in order to rely on disaggregation in the Directive.
- Although the Takeover Directive does not speak to the more technical issue of disaggregation, it already contains robust protections where otherwise unrelated or related persons are acting towards a common purpose with the intent of controlling or thwarting a bid for a company. Under the "acting in concert" provisions in the Takeover Directive "*natural or legal persons who cooperate with the offeror or the offeree company on the*

*basis of an agreement, either express or tacit, either oral or written, aimed either at acquiring control of the offeree company or at frustrating the successful outcome of a bid*<sup>11</sup> must aggregate their interests in a company for purposes of determining whether the mandatory bid threshold in the Directive has been reached.

- Thus, although the Transparency and Takeover Directives differ in their approach to disaggregation of holdings, they are largely consistent with respect to the treatment of holdings in a change in control context, casting a broad net to capture the activities of any investors when they are acting together to invest for control.

One possibility would be to restrict the ability of investment managers to rely on the disaggregation provisions in relation to the mandatory bid thresholds unless their investments are made in the ordinary course of business without the purpose or effect of changing or influencing control of the issuer. It would also be possible to make it a condition that they provide regular certifications to that effect to the regulator (and/or in their public filings under the Transparency Directive). This certification is based on similar provisions in US legislation regarding public disclosures of shareholdings by investment managers.

However, such a restriction would need to be combined with guidance to make clear that shareholder activities which involve the normal exercise of voting rights are not regarded as investing for control. Any such guidance would have to be carefully structured to ensure that it did not undermine the ability of institutional shareholders to play a responsible role in the governance of listed companies. The risk is that shareholders who wish to take advantage of disaggregation are discouraged from voting the shares they control on important decisions, such as changes to management, because of the concern that they lose the benefit of the disaggregation, either generally or in the particular case.

Arrangements which depend on analyses of intention (or self-certification) can create issues for regulators in verifying compliance. It may be that the rules could require firms to have some form of external audit or assessment of their practices and procedures if they wished to rely on disaggregation for the purposes of the mandatory bid thresholds.

There may also be other mechanisms that could be developed to address the risks of abuse if firms wished to take advantage of disaggregation in relation to the mandatory bid threshold.

Similar issues would arise in relation to the Prudential Assessment Directive but it could be argued that any more stringent requirements with respect to disaggregation around should only apply at the higher levels of control (20% and above). There would seem to be little substantive case at present for imposing more stringent requirements on disaggregation for the purposes of the Transparency Directive.

## **Conclusion**

The Commission should consider amendments to the Prudential Assessment Directive and Takeover Directive to bring them into line with the disaggregation rules in the Transparency Directive but should consider whether additional safeguards are necessary in relation to takeovers (and higher levels of control under the Prudential Assessment Directive) to protect the interests of minority shareholders (or the public interest in relation to financial institutions regulated under the Prudential Assessment Directive). In the meantime, it should seek to encourage Member States to develop a consistent approach to this issue.

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<sup>11</sup> Takeover Directive, Article 2(1)(d)

### **Footnote-transparency-related issues**

*Whilst this paper considers the issue of disaggregation and fund managers we note that similar issues and practical difficulties arise from the provisions of the Transparency Directive which permit certain combined holdings to be disregarded for the purposes of disclosure in relation to the question of whether the 5% threshold has been crossed (Art. 9.5, Art. 12.4 and Art. 12.5). These provisions are optional for holders, and in order to do take advantage of them, they need to notify the competent authority of each issuer a list of names of those management companies and investment firms for which the holdings should be disregarded and a statement that the parent company complies with the conditions for such exemption (Art. 6.2 and Art. 10.2 in the implementing Level 2 directive). The procedures for this can be complex and lengthy and they are not therefore always used when they could be. The result is that the signalling effects to the market will be confusing, because holdings that are equivalent on substance will be treated differently from a market transparency point of view depending on the choice of the manager. It could even be argued that the disclosure of the aggregated holdings of a parent company and a subsidiary market maker firm or fund management company would be misleading to the market, if there is no coordination in terms of exercise of voting rights.*

*The same problem may arise under Art. 9.6 in the Transparency Directive, which is optional to member states. Those member states that have opted for applying the exemption for trading book holdings under the provision will make investment firms in their jurisdiction subject to less demanding publication requirements than investment firms from other member states. From a market perspective, the result would also be corrupted, because in substance similar situations would be treated differently in terms of transparency. We recommend that these issues are considered further.*

## Annex 1

### Transparency Directive 2004/109/EC

#### **Article 12**

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4. The parent undertaking of a management company shall not be required to aggregate its holdings under Articles 9 and 10 with the holdings managed by the management company under the conditions laid down in Directive 85/611/EEC [the UCITS Directive], provided such management company exercises its voting rights independently from the parent undertaking.

However, Articles 9 and 10 shall apply where the parent undertaking, or another controlled undertaking of the parent undertaking, has invested in holdings managed by such management company and the management company has no discretion to exercise the voting rights attached to such holdings and may only exercise such voting rights under direct or indirect instructions from the parent or another controlled undertaking of the parent undertaking.

5. The parent undertaking of an investment firm authorised under Directive 2004/39/EC [the Markets in Financial Instruments Directive] shall not be required to aggregate its holdings under Articles 9 and 10 with the holdings which such investment firm manages on a client-by-client basis within the meaning of Article 4(1), point 9, of Directive 2004/39/EC, provided that:

— the investment firm is authorised to provide such portfolio management under point 4 of Section A of Annex I to Directive 2004/39/EC;

— it may only exercise the voting rights attached to such shares under instructions given in writing or by electronic means or it ensures that individual portfolio management services are conducted independently of any other services under conditions equivalent to those provided for under Directive 85/611/EEC by putting into place appropriate mechanisms; and

— the investment firm exercises its voting rights independently from the parent undertaking.

However, Articles 9 and 10 shall apply where the parent undertaking, or another controlled undertaking of the parent undertaking, has invested in holdings managed by such investment firm and the investment firm has no discretion to exercise the voting rights attached to such holdings and may only exercise such voting rights under direct or indirect instructions from the parent or another controlled undertaking of the parent undertaking.

...

8. In order to take account of technical developments on financial markets and to ensure the uniform application of paragraphs 1, 2, 4, 5 and 6 of this Article, the Commission shall, in accordance with the procedure referred to in Article 27(2), adopt implementing measures:

...

(e) to clarify the conditions of independence to be complied with by management companies and their parent undertakings or by investment firms and their parent undertakings to benefit from the exemptions in paragraphs 4 and 5.

#### **Article 23**

...

6. Undertakings whose registered office is in a third country which would have required an authorisation in accordance with Article 5(1) of Directive 85/611/EEC or, with regard to portfolio management under point 4 of section A of Annex I to Directive 2004/39/EC if it had its registered office or, only in the case of an investment firm, its head office within the Community, shall also be exempted from aggregating holdings with the holdings of its parent undertaking under the requirements laid down in Article 12(4) and (5) provided that they comply with equivalent conditions of independence as management companies or investment firms.

7. In order to take account of technical developments in financial markets and to ensure the uniform application of paragraph 6, the Commission shall, in accordance with the procedure referred to in Article 27(2), adopt implementing measures stating that, by reason of its domestic law, regulations, or administrative provisions, a third country ensures the equivalence of the independence requirements provided for under this Directive and its implementing measures.

### **Transparency Implementing Directive 2007/14/EC**

#### ***Article 10 Conditions of independence to be complied with by management companies and investment firms involved in individual portfolio management***

(Article 12(4), first subparagraph, and Article 12(5), first subparagraph, of Directive 2004/109/EC)

1. For the purposes of the exemption to the aggregation of holdings provided for in the first subparagraphs of Article 12(4) and (5) of Directive 2004/109/EC, a parent undertaking of a management company or of an investment firm shall comply with the following conditions:

(a) it must not interfere by giving direct or indirect instructions or in any other way in the exercise of the voting rights held by that management company or investment firm;

(b) that management company or investment firm must be free to exercise, independently of the parent undertaking, the voting rights attached to the assets it manages.

2. A parent undertaking which wishes to make use of the exemption shall, without delay, notify the following to the competent authority of the home Member State of issuers whose voting rights are attached to holdings managed by the management companies or investment firms:

(a) a list of the names of those management companies and investment firms, indicating the competent authorities that supervise them or that no competent authority supervises them, but with no reference to the issuers concerned;

(b) a statement that, in the case of each such management company or investment firm, the parent undertaking complies with the conditions laid down in paragraph 1.

The parent undertaking shall update the list referred to in point (a) on an ongoing basis.

3. Where the parent undertaking intends to benefit from the exemptions only in relation to the financial instruments referred to in Article 13 of Directive 2004/109/EC, it shall notify to the competent authority of the home Member State of the issuer only the list referred to in point (a) of paragraph 2.

4. Without prejudice to the application of Article 24 of Directive 2004/109/EC, a parent undertaking of a management company or of an investment firm shall be able to demonstrate to the competent authority of the home Member State of the issuer on request that:

(a) the organisational structures of the parent undertaking and the management company or investment firm are such that the voting rights are exercised independently of the parent undertaking;

(b) the persons who decide how the voting rights are to be exercised act independently;

(c) if the parent undertaking is a client of its management company or investment firm or has holding in the assets managed by the management company or investment firm, there is a clear written mandate for an arms-length customer relationship between the parent undertaking and the management company or investment firm.

The requirement in point (a) shall imply as a minimum that the parent undertaking and the management company or investment firm must establish written policies and procedures reasonably designed to prevent the distribution of information between the parent undertaking and the management company or investment firm in relation to the exercise of voting rights.

5. For the purposes of point (a) of paragraph 1, 'direct instruction' means any instruction given by the parent undertaking, or another controlled undertaking of the parent undertaking, specifying how the voting rights are to be exercised by the management company or investment firm in particular cases.

'Indirect instruction' means any general or particular instruction, regardless of the form, given by the parent undertaking, or another controlled undertaking of the parent undertaking, that limits the discretion of the management company or investment firm in relation to the exercise of the voting rights in order to serve specific business interests of the parent undertaking or another controlled undertaking of the parent undertaking.

***Article 23 Equivalence in relation to the test of independence for parent undertakings of management companies and investment firms***

(Article 23(6) of Directive 2004/109/EC)

1. A third country shall be deemed to set conditions of independence equivalent to those set out in Article 12(4) and (5) of that Directive where, under the law of that country, a management company or investment firm as referred to in Article 23(6) of Directive 2004/109/EC is required to meet the following conditions:

(a) the management company or investment firm must be free in all situations to exercise, independently of its parent undertaking, the voting rights attached to the assets it manages;

(b) the management company or investment firm must disregard the interests of the parent undertaking or of any other controlled undertaking of the parent undertaking whenever conflicts of interest arise.

2. The parent undertaking shall comply with the notification requirements laid down in Article 10(2)(a) and (3) of this Directive.

In addition, it shall make a statement that, in the case of each management company or investment firm concerned, the parent undertaking complies with the conditions laid down in paragraph 1 of this Article.

3. Without prejudice to the application of Article 24 of Directive 2004/109/EC, the parent undertaking shall be able to demonstrate to the competent authority of the home Member State of the issuer on request that the requirements laid down in Article 10(4) of this Directive are respected.