Derivatives Under the New Italian Takeover Bids Regulation

On April 5, 2011, after two rounds of public consultation with market participants carried out in October 2010 and February 2011, CONSOB, the Italian Financial Regulator, approved Resolution no. 17731 (the Resolution). The Resolution contains several and significant amendments to the provisions on takeover bids set forth in CONSOB regulation 11971/1999 (Regulation 11971) and completes the implementation in Italy of the EU Takeover Bids Directive (Directive 2004/25/EC) begun in 2007 with the reform of Legislative Decree 58/1998 (the Single Financial Act).

Among the most significant amendments resulting from the Resolution, are those concerning the extension of certain mandatory takeover bids rules to derivatives granting a long position over listed shares of the target.

This Alert summarises this new regulatory framework.

Background

Italian takeover rules require any person acquiring more than 30 percent of an Italian-listed company’s shares to launch a mandatory takeover bid for the entire company. The same obligation to launch a mandatory offer also applies to any person holding more than 30 percent of a listed company’s shares without controlling a majority — who acquires more than 5 percent of the same company’s shares in a 12-month period.

Before the approval and enactment of the Resolution, shares of the target counted towards the 30 percent and 5 percent thresholds (the Relevant Thresholds) only included those directly or indirectly held (i.e. through trust companies or nominees) for which the holder had voting rights in shareholders’ meetings called to resolve upon the appointment and removal of the directors (the Voting Shares), which is one of the most relevant evidence of the existence of control over a company. Under the previous regime, neither physically-settled nor cash-settled derivatives were counted towards the Relevant Thresholds.

Between 2007 and 2009, following similar reforms in Europe and recent high-profile cases in which cash-settled derivatives and other contracts for difference were used to build up hidden stakes in listed issuers, the Italian Parliament delegated CONSOB to amend the current regulatory framework. CONSOB was also directed to extend general disclosure requirements and provisions governing mandatory takeover bids to cover equity positions held through cash-settled and physically-settled derivatives.

In fall 2009, CONSOB released a position paper inviting responses from market participants on several options for extending the general disclosure requirements and certain takeover rules to cash-settled derivatives.
Based on the findings of the 2009 preliminary survey and on the initiatives of reform of the disclosure regime applicable to cash-settled derivatives carried out by the European financial institutions, on the one hand, on April 5, 2011 CONSOB adopted the Resolution that, as described below, extends significant provisions regarding the mandatory takeover bids to derivatives granting long positions over the Voting Shares of the target. On the other hand, one month later, on May 6, 2011, CONSOB launched a new public consultation proposing a reform of the disclosure requirements to be extended to cash-settled derivatives.

The Main Changes Resulting From the Resolution

The new definitions of “derivatives”, “long position” and “short position”

The Resolution introduces specific definitions of “derivatives”, “long position” and “short position” for the purposes of the Italian mandatory takeover bids rules. The new definition of derivatives includes the MiFID definition of derivatives as transposed in the Single Financial Act, as well as any other financial instrument or agreement that entitles to hold a long or a short position over the underlying shares. CONSOB has clarified that this catch-all final provision aims at applying the new mandatory takeover bids rules to any type of derivative and contract that is subject to the fluctuations of the underlying Voting Shares.

For this reason, the Resolution defines “long position” as the financial position where the holder has an economic interest that is positively linked to the fluctuations of the underlying security. On the contrary, “short position” is defined as the financial position where the holder has an economic interest that is negatively linked to the fluctuations of the underlying security.

The New General Rule to Count Derivatives Towards the Relevant Thresholds for the Purposes of the Mandatory Takeover Bids

The core new provision introduced by the Resolution is the one stating that derivatives which grant a long position over the underlying Voting Shares of the target will be counted, in an amount equal to such underlying Voting Shares, towards the Relevant Thresholds to launch the mandatory takeover bid. If the number of the underlying Voting Shares can change, reference will be made to the maximum amount of Voting Shares provided for by the derivative.

In commenting this new provision, CONSOB stated that it follows the model adopted by the UK Takeover Code. It also aims at counting towards the Relevant Thresholds all the shares which constitute the underlying of derivatives and agreements that entitle to hold a long position regardless the fact that they are both cash or physically settled. This broad provision aims at catching holders of swaps, sale and repurchase agreements and other contracts having a symmetric payoff structure, as well as holders of long positions through derivatives having an asymmetric structure (e.g. the buyer of a call option or the seller of a put option).

The Calculation of the Relevant Thresholds and the Relevant Exemptions

The Resolution provides that the calculation of the Relevant Thresholds exclude derivatives which grant a long position over the underlying Voting Shares of the target if such derivatives:

a) Are traded on regulated markets
b) Have as their underlying Voting Shares of the target that have not been issued yet
c) Are subject to the provisions of shareholders’ agreements that aim to resolve any deadlocks or that apply in case of breach of these agreements
d) Are held by banks or financial intermediaries to hedge clients’ positions.

The exclusions under (a) and (b) are justified on an valuable cost-benefit impact analysis: derivatives traded on regulated markets are executed at market standard conditions and are usually traceable and transparent. It is therefore unlikely that they can be used to build up hidden stakes and affect the target’s corporate governance. The same consideration applies to the exclusion under (b) where an impact on the corporate governance of the target can be excluded in principle since the underlying Voting Shares will be issued at a future time only.
The exclusion under (c) is justified by the circumstance that the provisions of certain clauses in shareholders’ agreement entitling a party to exercise, for instance, a call option, guarantee a legitimate exit from a shareholders’ agreement in case of deadlock or breach of the agreement. For this reason, CONSOB deems that any limits to this kind of clauses could be detrimental for the target company since they could impede favourable business arrangements. The exclusion under (d) reflects the so-called client serving exemption provided for by the UK Takeover Code\textsuperscript{20}. It aims at avoiding that, in case the derivative is executed with a financial intermediary, the obligation to launch the mandatory tender offer applies twice (e.g. a bank holding a short position that acquires a long position to hedge a contractual risk). It also aims at not imposing the obligation to launch the mandatory offer on a financial intermediary that has acquired a long position solely in order to allow the client to hold a short position (e.g. a bank selling a put option).

The Resolution also specifies that if the acquisition of the underlying Voting Shares of the target is subject to any authorisation from the competent authorities under the applicable laws (e.g. an antitrust clearance), the long position held through the derivative will be counted towards the Relevant Thresholds only upon the release of the authorisation, not before\textsuperscript{21}.

Moreover, the Resolution provides that netting between long and short positions on the same underlying Voting Shares of the target is admitted for the purposes of calculating the Relevant Thresholds to the extent that netting applies to derivatives of the same type executed with the same counterparty at the same terms and conditions\textsuperscript{22}.

**Temporary Holding Exemption**

Where the Relevant Thresholds have been exceeded as a consequence of the purchase of derivatives entitling to hold a long position in the underlying Voting Shares of the target, such a purchase can be exempted from the obligation to launch the mandatory takeover bid upon the occurrence of two conditions: the holder of the relevant long position i) has undertaken to sell to non-related parties the derivatives or the underlying Voting Shares within six months of the execution of the contracts granting the long position, and ii) does not exercise during such a period the voting right attached to the underlying Voting Shares\textsuperscript{23}.

**The Offering Price When the Relevant Thresholds are Reached Through Derivatives**

With respect to the offering price of the mandatory takeover bid following the purchase of derivatives which entitle to hold a long position in the underlying Voting Shares of the target, the Resolution states\textsuperscript{24} that it has to be determined adding the consideration paid by the purchaser of the long position to the reference price. Reference price is intended as the economic value of the underlying shares agreed between the parties to the derivative. According to CONSOB, such reference price is equal to (i) the strike price for the options; (ii) the initial reference price on the basis of which periodic financial flows are settled with respect to swaps and contracts for difference; and (iii) the sale and repurchase price for future forward contracts and similar agreements. In case of sale of put option agreements, the premium has to be deducted from the strike price.

**The New Disclosure Rules Applicable to Derivatives in the Course of a Takeover Bid**

Another significant amendment introduced by the Resolution is the extension of the disclosure requirements which apply during the takeover bids to any derivatives (both cash-settled and physically-settled) which are related to the Voting Shares of the target.

In particular\textsuperscript{25}, during the offering period, any person interested in the offer (i.e. the offeror, the target, their respective controlling company, subsidiaries, companies under common control or affiliates, directors, statutory auditors, general managers, shareholders of the offeror or the target who are parties to a relevant shareholders’ agreement affecting the voting rights and the corporate governance of Italian listed issuers and
any persons acting in concert\(^{26}\) shall disclose to CONSOB and to the market the essential terms of any transaction that such a person has carried out, directly or indirectly through nominees or subsidiaries, on derivatives which are in whatsoever manner linked to the shares of the target. The disclosure is due by the same date of execution of the relevant transaction. In describing such new disclosure rule, CONSOB stated that it is intended to enhance the transparency towards the market and investors during the offering period through a full coverage of any purchase and sale of derivatives both cash and physically settled, negotiated on regulated markets and over the counter.

**The Extension of the Best Price Rule to Derivatives**

The Resolution extends the so-called best price rule to derivatives which grant long positions in the underlying Voting Shares of the target. Under the new provision\(^ {27}\), if, during the offering period the offeror or any person acting in concert with the offeror acquires, directly or indirectly, such long positions for a price that is higher than the offering price, the offeror should have to adjust the offering price to the higher amount paid for such a long position.

The same best price rule applies in case the relevant purchase occurs in the six months following the completion of the offer to the extent that the purchase relates to more than 0.1 percent of the Voting Shares of the target. In this case, the Offeror shall pay only to those who joined the tender offer an adjustment price according to the terms set out in a specific press release.

It is worth noting that the best price rule above does not apply to purchase transactions carried out at market standard conditions for the purposes of proprietary trading only provided that (i) the purchases carried out during the offering period relate to not more than 0.5 percent of the Voting Shares of the target subject to the offer\(^ {28}\), or (ii) the purchases carried out in the six months following the completion of the offer relate to not more than 1 percent of the Voting Shares of the target subject to the offer. In describing such exemptions, CONSOB stated that proprietary trading transactions at market standard conditions are not in principle able to impact significantly the offering price since they are usually temporary transactions carried out for pure financial purposes.

**Entry Into Force and Transitional Regime**

The Resolution came into force on May 2, 2011 (the Initial Date). Given the significant impact of the reform, the Resolution has provided the following transitional regime applicable to the new provisions concerning the derivatives:

i. Derivatives that grant a long position over the underlying Voting Shares held before the Initial Date are counted towards the Relevant Thresholds only if further purchases are made after the Initial Date provided that such purchases are not a mere performance of an undertaking agreed before the Initial Date.

ii. Any person exceeding at the Initial Date the Relevant Thresholds as a result of ownership of derivatives that grant a long position over the underlying Voting Shares is required to launch a mandatory takeover bid upon the purchase of further Voting Shares, including any Voting Shares being the underlying of the derivative owned.

iii. Any person exceeding the Relevant Thresholds because of the purchase of derivatives that grant a long position over the underlying Voting Shares occurred in a period comprised between April 9, 2011 and the Initial Date has to launch the mandatory takeover bid unless it reduces its stake in the target below the Relevant Thresholds within May 2, 2013.

In addition to the above, under the Resolution any of the following person exceeding at the Initial Date the Relevant Thresholds Italian as a result of holding any derivatives that grant a long position over the underlying Voting Shares have been requested to publish within the following five trading days of the Initial date a press release with all the relevant details on the interest held in the target. Such reporting obligation...
applied to Italian listed issuers and other European listed issuers that have chosen Italy as their Home Member State for the purposes of the Transparency EU Directive, their controlling shareholders, directors, statutory auditors, key managers, any person holding a relevant interest in a listed issuer exceeding 2 percent and any other party to a shareholders’ agreement affecting the voting rights and the corporate governance of an Italian listed issuer.

Endnotes

1 The Resolution was published in Italian Official Gazette no. 81 of April 8, 2011, S.O. n. 95.

2 See Legislative Decree 146/2009 that implemented at the legislative level the Takeover Directive.

3 See article 106, paragraph 1 of the Single Financial Act.


5 For instance in the UK and France.


8 See Article 105, paragraph 3-bis, of the Single Financial Act, inserted by Article 2 of Legislative Decree 146/2009.


11 The consultation closed on June 6, 2011. On June 21, 2011, CONSOB published the responses of the market participants and is now expected to review such responses and finalise the new disclosure rules.

12 See Article 35, paragraph 1, letter i) of the Issuers Regulation.


14 According to Article 1, 3rd par., of the Single Financial Act, derivatives are referred to as: “… (d) options, futures, swaps, forward contracts on interest rates and other derivative contracts linked to securities, currency, interest rates or returns, or other derivatives, financial indices or measures that may be settled by the physical delivery of the underlying asset or by cash payment of differentials; (e) options, futures, swaps, interest rate swaps, and any other derivative contracts on commodities, whose settlement is by payment of the differentials in cash, or at the discretion of one of the parties, except in cases where such option is the result of default or other event leading to termination of the contract; (f) options, futures, swaps and other derivative contracts on commodities, whose settlement may be by physical delivery of the underlying asset and which are traded on a regulated market and/or multilateral trading systems; (g) options, futures, swaps, forward contracts and other derivative contracts on commodities, whose settlement may be by physical delivery of the underlying asset, other than those indicated in paragraph (f), that have no commercial purpose, and with the characteristics of other derivatives, taking into consideration, amongst other things, whether they are cleared and executed through recognized clearing houses or whether they are subject to regular margin calls; (h) derivatives for the transfer of credit risk; (i) differential financial contracts; (j) options, futures, swaps, forward contracts, swaps, futures contracts on interest rates and other derivative contracts related to climatic variables, transport rates, emission levels, inflation rates or other official economic statistics, settled by cash payment of differentials or at the discretion of one of the parties, except in cases where such option is the result of default or other event leading to cancellation of the contract and other derivative contracts on assets, options, bonds, indices and measures other than those indicated in previous paragraphs, with the characteristics of other derivative financial instruments, taking into consideration, amongst other things, whether they are traded on a regulated market or multilateral trading systems, whether they are cleared and executed through a recognized clearing house or whether they are subject to regular margin calls, and (d-bis) any other cash-settled security determined on the basis of an underlying security (such as shares, bonds) or on the basis of commodities, interest rates, indexes and currencies”.

15 See Article 35, paragraph 1, letter g) of the Issuers Regulation.

16 See Article 35, paragraph 1, letter h) of the Issuers Regulation.
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17 See Article 44-ter, paragraph 1, of the Issuers Regulation.
18 See Rule 9.1 of the Takeover Code.
19 See Article 44-ter, paragraph 2, of the Issuers Regulation.
21 See Article 44-ter, paragraph 3, of the Issuers Regulation.
22 See Article 44-ter, paragraph 4, of the Issuers Regulation.
23 See Article 49, paragraph 1, letter f) of the Issuers Regulation.
24 See Article 44-ter, paragraph 6, of the Issuers Regulation.
25 See Article 41, paragraph 2, letter c), number 2) of the Issuers Regulation.
26 See Article 35, paragraph 1, letter b), of the Issuers Regulation.
27 See Article 42, paragraphs 2 and 3, of the Issuers Regulation.
28 See Article 42, paragraph 4 of the Issuers Regulation.