Singapore Management University
Institutional Knowledge at Singapore Management University

Research Collection Yong Pung How School Of Law
Yong Pung How School of Law

1-2012

Equity Swaps and Implications in Company Law: An Examination of Singapore Law

Chao-hung Christopher CHEN
Singapore Management University, chchen@smu.edu.sg

Follow this and additional works at: https://ink.library.smu.edu.sg/sol_research

Part of the Business Organizations Law Commons

Citation

CHEN, Chao-hung Christopher. Equity Swaps and Implications in Company Law: An Examination of Singapore Law. (2012). 1-78.
Available at: https://ink.library.smu.edu.sg/sol_research/1066

This Working Paper is brought to you for free and open access by the Yong Pung How School of Law at Institutional Knowledge at Singapore Management University. It has been accepted for inclusion in Research Collection Yong Pung How School Of Law by an authorized administrator of Institutional Knowledge at Singapore Management University. For more information, please email cherylds@smu.edu.sg.

EQUITY SWAPS AND IMPLICATIONS IN COMPANY LAW: AN EXAMINATION OF SINGAPORE LAW

CHRISTOPHER CHEN*

Abstract

This article explores issues from the use of equity swaps by corporate stakeholders under Singapore law. The article accepts that non-disclosure of economic interests might have an impact on market efficiency and corporate governance. To address potential problems, Singapore should consider revising the Takeover Code, while it requires further regulatory impact analysis to decide whether amendments to the Securities and Futures Act and the Companies Act are needed. As an alternative, companies can use their articles of association to impose a duty of disclosure before statutory intervention. In addition, the trading of equity swaps by directors raises issues about fiduciary duties. Although companies can probably trade equity swaps that reference their own shares, it is likely the financial assistance rule will be breached if the market reality stands.

Keywords

Financial derivative, equity swap, company law, fiduciary duty, financial assistance, disclosure, interest in shares, corporate governance

A. INTRODUCTION

This article focuses on equity swaps, a form of cash-settled equity derivatives, and their implications under Singapore's company law. The rise of financial derivatives has posed many questions. Apart from their implications in financial regulation, one less explored issue is the implication of derivatives for other traditional areas of law. In the context of company law, equity derivatives—derivatives that refer to shares of a company—may raise some important issues. These issues have not been fully explored in Singapore, one of the major financial centres in Asia. For simplicity, this article focuses only on equity swaps and issues in company. However, some issues relating to securities regulation and takeover law will be considered. Similar arguments may be extended to other cash-settled equity derivatives and similar issues may also arise in other countries.

The rise of derivatives has challenged the traditional view of the agency problem. Traditionally, shares connote ownership of a company and a right to claim any residual value when the company is liquidated.[1] For large corporations, the so-called agency problem arises because actual control of the company can be separated from ownership rights.[2] Company law seeks to address the agency problem by conferring a variety of rights on shareholders. The underlying assumption is that shareholders are likely to consider their self-interest in exercising such rights and take care in doing so to avoid having a negative effect on the share price.

The use of derivatives, which serve the function of taking or transferring risk, may change the balance among corporate stakeholders. By trading derivatives, the risk associated with an asset can be separated from its ownership. Thus, equity swaps may lead to a situation where the person who holds shares is no longer interested in the company's business because the downside of shareholding has been transferred to another person. Thus, he may not vote in favour of resolutions likely to promote his personal interests, not to mention those that further the interests of the company. The problem of "empty voting" thus arises.[3]

In contrast, the party who takes on the risk of shareholding via an equity derivative becomes a "hidden owner" of the shares by acquiring economic

* Assistant Professor of Law, Singapore Management University.

[1] CH Tan (ed.), *Walter Woon on Company Law* (Sweet & Maxwell, rev. 3rd Ed, 2009), 424.

[2] MC Jensen and WH. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305, 308.

[3] See generally HTC Hu and B Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions" (2008) 156 *University of Pennsylvania Law Review* 625 ("Empty Voting II"); HTC Hu and B Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership" (2006) 79 *Southern California Law Review 811* ("Empty Voting I").

interests in the shares without actually owning them. He has incentives to have a say in the company's affairs, but has no right to vote. This scenario might create a situation where a person genuinely interested in the company's business has no right to vote, which is left to a person without any economic interest in the company.

So far, equity swaps raise eyebrows when a party converts his "hidden ownership" into real ownership, especially during a battle for corporate control. This situation may have further implications for disclosure rules and takeover laws. This issue has been exposed by several judgments and has attracted much academic discussion. However, the use of equity derivatives is not limited to shareholders. Like stock option holders, other corporate stakeholders and the company itself might also use equity swaps for various purposes. As this article will elaborate below, there may be legal problems other than the disclosure of shareholdings.

In this article, we will consider some issues in the broader context of corporate law, not limited to rules related to listed companies or takeovers. The rest of the article is organized as follows. The first part briefly introduces derivative instruments and equity swaps. Part III will start with the discussion of the disclosure of substantial shareholdings, especially when the "market reality" stands. Part IV considers the use of equity swaps by company management or the company itself. Part V concludes the article.

B. DEFINITION OF EQUITY SWAPS

1. SWAP TECHNIQUES AND EQUITY SWAPS

In short, equity swaps are a class of "financial derivatives", which "can be defined as a financial instrument whose value depends on (or derive from) the values of other, more basic underlying variables".[4] From one perspective, derivatives "allow trading in the return or price fluctuations of other assets without the necessity of trading in the assets themselves".[5] Moreover, "applications of derivative instruments focus on using derivatives to transfer risk".[6] Thus, derivatives allow market participants to invest in assets beyond the limits of national boundaries or to spread risk to other corners of the world. Depending on the form of the transaction, derivatives can be classified into four types: options (i.e. the right to buy or sell something in the future at a pre-determined price),

---

[4] J Hull, *Options, Futures, and Other Derivatives* (Prentice Hall, 6th Ed, 2006), 1; Christopher Chao-hung Chen, *Trading Risks: the Contractual Nature of Derivative Instruments and Certain Regulatory Issues* (VDM, 2010), 29-37.

[5] S Das, *Derivative Products & Pricing* (John Wiley & Sons, 3rd Ed, rev Ed, 2006), 4.

[6] S Das, *Structured Products Volume 1: Exotic Options; Interest Rates & Currency* (John Wiley & Sons, 3rd Ed, rev Ed, 2006), 117.

forward contracts (a contract to buy or sell something in the future at a price fixed in the present), futures contracts (forward contracts traded on an exchange), and swaps (an exchange of future cash flows[7]). Options and forward contracts are the most basic types of derivatives.[8] Some derivatives can lead to physical delivery of the underlying assets. However, most derivatives end up being cash settled to become "contracts for differences".[9] In addition, derivatives can be traded on an exchange or in the over-the-counter (OTC) market. In the OTC market, market participants commonly use the standard form published by the International Swaps and Derivatives Association ("ISDA").

An equity swap is a kind of equity derivatives, which are derivative instruments referencing to shares of a company or an equity index. In particular, typical equity swaps apply a total return structure, under which one party (X) pays an amount equivalent to the increase in price and the income payable for an underlying instrument to the counterparty (Y) in return for Y's promise to make a fixed payment (quoted as an interest rate) and compensate X for any downward price movement. In short, under an equity swap, Y (the "long party") makes a fixed or floating interest payment (the swap rate) to X (the "short party") on a notional amount plus any depreciation in the equity price or index in exchange for X paying the return on a stock price or an equity index (including any price appreciation and dividends distributed), calculated notionally in monetary terms.[10] Under the total return structure, X foregoes the upside of a financial instrument in favour of Y, who takes the downside risk of the instrument. In other words, Y acquires the benefit of holding the financial instrument by paying the swap rate.

2. FUNCTION OF EQUITY SWAPS

The total return structure of equity swaps might help the long and short parties to achieve many objectives ranging from hedging to pure speculation. Their most intriguing application is in a battle for corporate control.

(A) HEDGING AND SPECULATION

Equity swaps could be equally used for hedging or speculative purposes. Hedging is most clearly the purpose when a shareholder is the short party. For example, a holding company might need to maintain its company shareholding, but seek to

---

[7] Payment on settlement date is usually made on a net basis. This is commonly called 'payment netting'. *See* ISDA Master Agreement (2002 version) s 2(c).

[8] S Das, *Derivative Products & Pricing* (John Wiley & Sons, 3rd Ed, rev Ed, 2006), 8; A Hudson, *The Law on Financial Derivatives* (Sweet & Maxwell, 4th Ed, 2006), 2-05.

[9] See e.g., *Morgan Stanley UK Group v Puglisi Cosentino* [1998] CLC 481 (Comm Ct); *City Index Ltd v Leslie* [1992] QB 98 (CA).

[10] *Ibid*, 81.

hedge itself in case of market fluctuations. The company might enter into an equity swap as the short party so any downward movement in the share price is covered by the long party.

First, a long party might also hedge with equity swaps. A real example was the use of equity swaps by Sino-Environment Technology Group Ltd ("Sino-Env") in Singapore in 2008. The company planned to issue convertible bonds. To hedge the risk of dilution of Sino-Env's shares if bondholders exercised their conversion rights, Sino-Env entered into an equity swap with Morgan Stanley.[11] The equity swap was funded by the proceeds of the bond issue. The underlying rationale seemed to be that the company (being the long party) might gain from a higher share price (when bondholders might convert their bonds into shares) so that any impact on the dilution of shares would be reduced. However, it was not clear how the swap could match the risk of dilution.

Second, equity swaps may be used for speculation. For example, equity swaps allow the long party to create a synthetic investment in company shares without physical holding them. From the long party's perspective, this type of transaction is similar to a margin transaction without borrowing money from a lender. From the short party's perspective, it is like short selling without actual selling in the market.

Moreover, equity swaps can be used to enhance equity returns (e.g. by reducing transaction costs incurred when trading shares on an exchange) or to gain liquidity without actually losing exposure.[12] They may also be used for tax reasons or portfolio management.[13] In one real example, Vivendi complied with the European Commission's requirement to dispose of its British Sky Broadcasting ("BSB") shares as a condition of its acquisition of a Canadian company. By entering into equity swaps with Deutsche Bank (the buyer of the shares), Vivendi maintained its economic exposure to BSB without losing control of BSB to outsiders.[14] The only limit on how equity swaps may be used in real transactions is the creativity of market participants.

---

[11] http://info.sgx.com/webcoranncatth.nsf/VwAttachments/Att_47B2E36519E2F5F9482574640017F08A/$file/10_Jun_2008_Explanation_of_Swap.pdf?openelement, accessed on 9 February 2011.

[12] S Das, *Structured Products Volume 2: Equity; Commodity; Credit & New Markets* (John Wiley & Sons, 3rd Ed, rev Ed, 2006), 96-100.

[13] E.g. in *Ithaca (Custodians) Ltd. v. Perry Corp.* [2004] 1 NZLR 731, the long party argued that the transactions in question were driven by tax reasons.

[14] Das, *supra* n 12, 101-102.

(B) THE USE OF EQUITY SWAPS IN A BATTLE FOR CORPORATE CONTROL

It is common knowledge that parties may mount takeover offers or compete for corporate control by first entering into equity swaps with a bank before converting their economic interest into physical shares at a later date. The latest high profile example of this type of takeover strategy is the battle between Hermès and LVMH, two major luxury goods makers in France.[15]

Another high profile case occurred in the US. In *CSX Corp v The Children's Investment Fund Management (UK) LLP*[16], a US court considered the issue of whether the two hedge funds involved, The Children's Investment Fund and 3G, were considered "beneficial owners" of CSX shares under the rules of the Securities Exchange Commission.[17] In 2007, the two hedge funds engaged in a battle with the board of CSX Corp ("CSX"), a listed railway company, over their leveraged buyout proposal.

To avoid triggering mandatory disclosure rules under US law,[18] the two hedge funds entered into a series of equity swaps with several banks, none of which held more than 5% of CSX shares. While preparing for a proxy battle, the two hedge funds unwound some of their swaps before acquiring physical shares from the banks. In the meantime, the two hedge funds also disclosed their swap positions in relevant statements regarding substantial shareholdings and proxies. The board of CSX countered that the two hedge funds should not be allowed to vote for a violation of federal regulations. The key issue was whether the two hedge funds should have been considered "beneficial owners" of CSX shares due to their acquisition of economic interests via equity swaps.

The facts of *CSX* are revealing. Though there was no express agreement between the parties, it was common market practice for counterparty banks to purchase physical shares as a hedge (for swaps), and the voting outcome for these shares was predictable. Moreover, by causing the banks to purchase shares as a hedge, the hedge funds could prevent other people from exercising the voting rights attached to the shares. It was also common practice for the long party to cause counterparty banks to sell their shares by unwinding the swaps.

However, the US court declined to reach a firm decision on whether the two hedge funds had voting or investment powers as beneficial owners because they could be deemed to have acquired such powers through a scheme to evade

---

[15] 'The Second Handbag War', *The Economist*, 29 December 2010, available at http://www.economist.com/node/17805643?story_id=17805643, accessed on 9 March 2011.

[16] 562 F Supp 2d 511 (SDNY 2008) ("*CSX*").

[17] 17 CFR 240.13d-3(a).

[18] Securities Exchange Act § 13(d), 15 USC 78m(d).

disclosure rules.[19] Ultimately, though the US court issued an injunction to forbid future violations of relevant regulations, the two hedge funds were allowed to exercise the voting rights attached to their shares because there was no material misstatement in relevant statements. As a result, the two hedge funds won the proxy battle.[20] The *CSX* judgment is the subject of a considerable amount of academic discussion in the US.[21] Similar issues have arisen in Italy, Spain, and Australia.[22] Unsurprisingly, existing shareholders might adopt the same strategy to defend an approach from an offeror.[23]

A similar strategy may also be adopted without a takeover offer. For example, in *Ithaca (Custodians) Ltd v Perry Corp*[24], Perry Corp initially held just over 10% of Rubicon Ltd, a listed company in New Zealand, but it had later sold a large part of its shareholding to two banks in transactions matched by equity swaps for the same amount of shares between the same parties.[25] A dispute arose from the sale of shares in a third party company held by Rubicon. To ensure the company made a decision in line with Perry Corp's wish, Perry Corp unwound the equity swaps before purchasing a substantial number of Rubicon shares from the banks involved (the short parties to the swaps). The legal issue then became whether Perry Corp had violated New Zealand law on the disclosure of substantial shareholdings. The New Zealand Court of Appeal decided that mere acquisition of an economic interest via a swap did not constitute a "relevant interest" under

---

[19] 17 CFR 240.13d-3(b).

[20] "*TCI and 3G Secure Places on CSX Board*", *Financial Times*, available at http://www.ft.com/cms/s/0/c4fcb508-5362-11dd-8dd2-000077b07658.html, accessed on 22 January 2009).

[21] See generally BT Sullivan, "CSX Corp v Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership" (2009) 87 *North Carolina Law Review* 1300; RT. Law, "The Derailment of Section 13(D) Liability after CSX v Children's Investment Fund: An Argument for Maintaining the Beneficial Ownership Requirement for Section 13(D) Disclosure" (2009) 59 *Catholic University Law Review* 259; E Khasina, "Disclosure of 'Beneficial Ownership' of Synthetic Positions in Takeover Campaigns" (2009) *Columbia Business Law Review* 904; SM Donahue, "Lessons Learned from CSX Corp v Children's Investment Fund Management and Proposals for Reform" (2010) 4 *Brooklyn Journal of Corporate, Financial & Commercial Law* 221; D Bertaccini, "To Disclose or Not to Disclose? CSX Corp, Total Return Swaps, and Their Implications for Schedule 13D Filing Purposes" (2009) 31 *Cardozo Law Review* 267.

[22] See *E.On AG v. Acciona, SA*, 2006 US Dist LEXIS 84179 (SDNY 2006); *Glencore International AG and Another v Takeovers Panel* [2006] FCA 724; Lisa Curran and Francesca Toritto, *FIAT/IFIL: The Securities Law Implications for Equity Derivatives*, (2006) 21 JIBFL 297; Hu and Black, Empty Voting II , *supra* note 3, at 661 *et seq*.

[23] E.g., in *E.On AG v. Acciona, SA*, 2006 US Dist LEXIS 84179 (SDNY 2006), Acciona (a major shareholder) defended the tender offer made by E.On AG by entering into several equity swaps with a Spanish bank.

[24] *Ithaca (Custodians) Ltd. v. Perry Corp.* [2004] 1 NZLR 731 ("*Ithaca*").

[25] *Ibid*, at [18].

New Zealand law at the time.[26] The court also held that there had to be a form of communication to illustrate a meeting of minds among the parties to qualify as "an agreement, arrangement or understanding". Thus, the court held in favour of Perry Corp.

(C) MARKET REALITY AND REASONS TO ENTER INTO EQUITY SWAPS IN A TAKEOVER BATTLE

The cases outlined above share some common features. First, there was no express agreement in the swap agreements obliging the short party to sell shares to the long party or to determine how voting rights should be exercised. Second, it was common market practice for the short party to purchase physical shares to hedge the swap exposure, though there was no express provision obliging the short party to do so. Third, another common feature of these cases was the short party's willingness to sell the shares to the long party once the swap had been terminated. This is the "market reality" that arose in both *CSX* and *Ithaca* and is referred in the rest of this article, though its existence was not evidenced by contractual documents.

There are certain benefits to build up one's economic exposure before mounting a real takeover attack. As in *CSX*, a long party might circumvent the application of mandatory disclosure rules relating to substantial shareholdings and/or mandatory bid rules once their shareholding exceeds a certain threshold. First, the long party may avoid (or at least delay) price fluctuations caused by disclosure. This may reduce the cost of the takeover. Moreover, the long party may take a strategic position to ambush the target company by staying in the shadows until the last moment.[27] The board of the target company might be less informed and thus less prepared, thereby boosting the chance of success. In addition, if the market reality stands, some of the company's shares would be frozen in the hands of the short party, thereby reducing the voting ammunition of other shareholders. This might be crucial in a battle for corporate control, even if the long party does not ultimately acquire the company's shares.

C. DISCLOSURE OF SUBSTANTIAL SHAREHOLDINGS

How would Singapore law cope with the situation that arose in *Ithaca* or *CSX*? In a battle for corporate control, the legal question is: how shall we accommodate this market reality where there is no express agreement between the parties regarding the exercise of voting rights or disposal of shares? Under Singapore law, the key issue is whether the long party ("L") in an equity swap has acquired an

[26] *Ibid*, at [57].
[27] *Ibid*.

interest in the shares of the reference company ("Company X") through the equity swap executed with the short party ("S"). In Singapore, there are three sources of legal authority on this point: the Companies Act (Cap 50, 2006 Revised Edition) ("CA") for all companies; the Securities and Futures Act (Cap 289, 2006 Revised Edition) ("SFA") for listed companies; and the Singapore Code of Takeovers and Mergers in the case of a takeover offer.

1. Interpretation of Singapore law

(a) Companies Act

Substantial shareholders, defined as persons who have an interest in over 5% of the voting shares of a company, are required to notify the company of their interest in the company's shares.[28] In the case of equity swaps, the question is whether the long party possesses an "interest in shares" pursuant to section 7 of the CA. Because an equity swap does not create a proprietary interest in shares or an indirect shareholding via a connected person,[29] the most likely source of authority for an interest in shares is the "deemed interest" under section 7(6) of the CA:

> Where a person —
> (a) has entered into a contract to purchase a share;
> (b) has a right, otherwise than by reason of having an interest under a trust, to have a share transferred to himself or to his order, whether the right is exercisable presently or in the future and whether on the fulfilment of a condition or not;
> (c) has the right to acquire a share, or an interest in a share, under an option, whether the right is exercisable presently or in the future and whether on the fulfilment of a condition or not; or
> (d) is entitled (otherwise than by reason of his having been appointed a proxy or representative to vote at a meeting of members of a corporation or of a class of its members) to exercise or control the exercise of a right attached to a share, not being a share of which he is the registered holder,
>
> that person shall be deemed to have an interest in that share.

There is no problem fitting equity swaps into the ambit of section 7(6) if there is an express agreement between L and S regarding the transfer of shares to L or the exercise of voting rights by S because there is a contract (though potentially contingent) to purchase a share. However, as seen in *Ithaca* and *CSX*,

[28] CA, ss 81 and 82.
[29] CA, s 7(2) to (5); SFA, s 4(1) to (6).

the biggest challenge is where there is no express agreement but the market reality stands. This leads to two issues of construction.

First, can this market reality result in a "right" to acquire shares or exercise control over voting rights? The statutory wording of "right" indicates a strong form of legal relationship. One may hardly justify the existence of a "right" (or conversely, an obligation) without any sort of agreement, because there is always a chance that the parties might behave in another way.

In addition, parties normally execute contracts regarding swaps at the outset of a transaction. Thus, it may be going too far for the court to imply an additional contract between L and S regarding the purchase of shares in Company X or the exercise of voting rights if the agreement does not include provisions dealing with future purchases or voting rights from the outset. As indicated by the New Zealand Court of Appeal in *Ithaca*, mere market reality does not justify a meeting of minds.[30] Given that neither transferring shares nor exercising voting rights is inherently necessary to an equity swap, there is little room to imply such a contractual term.[31]

Second, another argument is that swaps should be treated as options, which are not defined in either the CA or the SFA. In theory, equity swaps could be seen as a combination of forward contracts.[32] From the long party's perspective, he pays a price (i.e. interest) to claim future dividends or reap the benefit of any increase in the share price. Thus, L's position is somewhat similar to holding a call option on the shares of Company X.

However, there must be a "right" to acquire a share under section 7(6)(c). Thus, whether or not it is an option, the true legal question is whether such a right exists. Furthermore, one might also argue that the long party also has an obligation to compensate the short party for any fall in the share price. Thus, a swap is not identical to a typical option, where the option holder has a right to exercise, not an obligation to perform.

In sum, a literal reading of section 7 of the CA leads to the conclusion that L's position under a cash-settled equity swap does not qualify as an interest in Company X's shares if there is no agreement that results in a "right" to acquire such shares or exercise voting rights.

(B) SECURITIES AND FUTURES ACT

Section 137 of the SFA imposes a duty on substantial shareholders to notify the stock exchange of their holdings. The statutory wording is largely identical to the equivalent section of the CA. There is a similar problem concerning "deemed

[30] *Ithaca*, *supra* n 24, [69].
[31] The 2002 ISDA Equity Derivatives Definitions contain no provisions regarding the transfer of shares or the exercise of voting rights for a cash-settled equity swap.
[32] Das, *supra* n 12, 81.

interests" under Section 4(7) of the SFA, which shares the same problems presented by s 7(6) of the CA.

One additional question under the SFA is whether L could be said to have "authority (whether formal or informal, or express or implied) to dispose of, or to exercise control over the disposal of, those securities".[33] If the market reality stands, it is likely that L has *de facto* authority to exercise control over S's disposal of shares by unwinding the swap. It is unclear whether the term "authority" refers to the legal meaning in the agency context or simply means a kind of "power".

If it is limited to a legal authority, it is doubtful whether such *de facto* authority could be translated into an implied authority as a matter of law when there is no express agreement between the parties. The Mainboard Rules of the Singapore Exchange ("SGX") do not clarify the situation, as the relevant rules refer only to direct and deemed interests without describing such interests any further.[34]

If the term "authority" means a power to dispose of shares or exercise control, there is a higher likelihood that such *de facto* authority might be treated as the "authority" referred to in Section 4(1) of the SFA. It has been commented that "[c]ontrol over voting or disposition of a security will also confer a notifiable interest".[35] Thus, if we take the purpose of disclosure as the key criterion, there could be a stronger argument that the term "authority" includes this kind of *de facto* authority. If so, a long party might have to disclose his economic interest to the exchange if the market reality stands. Nonetheless, this interpretation would have to be confirmed by the courts or clarified by future amendments of the SFA.

(C) SINGAPORE CODE OF TAKEOVERS AND MERGERS

If *CSX* were to occur in Singapore, the Singapore Code of Takeovers and Mergers (the "Code") might be applicable. Broadly speaking, an offeror or offeree entering into an equity swap might trigger issues under the Code at two levels: disclosure of dealings in relevant securities, and disclosure in an offer document.

First, Rule 12 generally deals with the disclosure of dealings in "relevant securities" during a takeover offer. Note 3 of Rule 12 further clarifies that purchasing "relevant securities" includes "[t]he taking, granting or exercising of an option in respect of [the shares of the offeror or offeree]". However, unless an equity swap can be structured as an option, equity swaps may not fall within the scope of "relevant securities". In addition, Note 6(iv) of Rule 13 specifies that the details disclosed should include

[33] SFA s 4(1). This provision does not appear in the Companies Act.
[34] SGX Mainboard Rules 704 and Appendix 7.3.
[35] H Tjio, *Principles and Practice of Securities Regulation in Singapore* (LexisNexis, 2nd Ed, 2011), 442.

"the identity of the … ultimate beneficial owner or controller. Dealings by or on behalf of a principal include any dealings where the investment risk is directly or indirectly borne by one of the principals, e.g. where an associate has the right to sell to one of the principals at an agreed price any securities bought."

If we read Notes 3 and 6 together, one might argue that L might be deemed an "ultimate beneficial owner", as L bears the investment risk of the underlying shares. However, a fundamental problem is whether an equity swap is a "relevant security". Note 6 deals with the details that should be included in the disclosure, but does not solve the problem of how to define a "relevant security" under Note 3.

Second, Rule 23 deals with the offer document, including interests in the offeree company. Note 2 of Rule 23.3 provides that "[r]eferences to directors being 'interested' in shareholdings should be interpreted according to section 164 of the Companies Act". However, an "interest in shares" under s 164 refers to s 7 of CA. Relevant issues have been discussed above.

There are two further problems. First, the definition of "relevant shareholding" does not specifically use the term "swap".[36] Thus, we face the familiar question discussed earlier of whether a swap can be deemed an option. While it may still be possible to treat a swap as an option if we define the term broadly, it is suggested that the market regulator or the courts ought to clarify this point in future.

A second and more interesting question is whether S could be deemed to be a person acting in concert with L (being an offeror). The Code provides that persons acting in concert "comprise individuals or companies who, pursuant to an agreement or understanding (whether formal or informal), cooperate, through the acquisition by any of them of shares in a company, to obtain or consolidate effective control of that company".[37] On this point, it is worth quoting the view of the Securities Industry Council ("SIC"), the principal regulator of the Takeover Code in Singapore:

Council has encountered a number of instances where the controlling shareholder proposed to purchase [contract for differences (CFDs)] in respect of shares of his company which when added to his existing shareholdings would cause him to cross the mandatory offer thresholds. In such cases, Council's practice has been to confirm that the counterparty to the CFD would not be regarded as a concert party of the controlling

[36] See Note 1 of Rule 23.3.

[37] Code, Definition 1.

> shareholder, hence any shares bought by the counterparty to hedge the CFD would not be aggregated with those of the controlling shareholder for the purposes of determining whether a mandatory offer is triggered. Such confirmation is subject to (i) the counterparty putting in place proper procedures to ensure that the controlling shareholder cannot vote or influence the voting of the hedge shares acquired; and (ii) written confirmations from the controlling shareholder and the counterparty to the effect that they are not parties acting in concert.[38]

From this passage, as long as S ensures it is not subject to L's influence, the SIC would not consider S to be a person acting in concert. It is a method that may prevent *ex ante* mutual understanding from arising between the parties as in the *CSX* case. Nonetheless, if the market reality is that the voting outcome is normally predictable, L (as the offeror) may still have its wish fulfilled in a takeover battle. In addition, the intention of one or both of the parties might change over time. The short party and the long party might not be acting in concert at the start of the swap, but the long party might still emerge from the shadows at a later date. The surprise factor remains in existence under the SIC approach. The SIC has not yet made any proposal to change the Code. The question then becomes: should Singapore law be changed to address the issue?

2. MUST SINGAPORE LAW CHANGE?

(A) PROBLEMS OF NON-DISCLOSURE OF EQUITY SWAP POSITIONS

Before we discuss the question outlined above, we must first consider problems arising from the use of equity swaps when competing for corporate control. The question is then related to the purpose of mandatory disclosure of substantial shareholdings.

The primary purpose of such disclosure seems to be twofold: to improve the transparency of the ownership and voting structure of the company and, in turn, enhance the quality of its corporate governance.[39] The rationale is that the existence of and changes in a substantial shareholding might influence the substantial shareholder's impact on the monitoring of management, which could in turn influence the quality of the firm's corporate governance and the value of its shares.[40] Through ownership disclosures, existing and potential shareholders might acquire a better understanding of who has significant voting power in the

---

[38] Securities Industry Council, *Consultation Paper on Revision of the Singapore Code on Takeovers and Mergers* (Jun 2006), [67].

[39] MC Schouten, "The Case for Mandatory Ownership Disclosure" (2009) 15 *Stanford Journal of Law, Business & Finance* 127, 133-157.

[40] *Ibid*, 137-138.

general meeting, who has a trading interest in the company, major shifts of control, and share liquidity.[41] This information might influence shareholders' decisions on whether to sell or hold, and might also influence the market for corporate control. Overall, the view that mandatory disclosure leads to better corporate governance seems to be well accepted.[42]

Where economic interests are acquired via equity swaps, the function of mandatory ownership disclosure might be compromised. Not only would existing and potential shareholders have less information on who has real interests behind the scenes, but the problem of empty voting might undermine the rationale for granting shareholders voting rights: to exercise control.[43] There could be a further problem of moral hazard, as the short party might not consider the consequences of his vote before casting it if the long party will compensate him for any fall in the value of his shareholding.[44] In the UK, the FSA also formed the view that non-disclosure of economic interests acquired through contracts for differences might lead to market failures such as information asymmetry, a distorted market for corporate control, and diminished market confidence.[45]

However, there are counter-arguments. First, the impacts of empty voting and hidden ownership hinge upon the short party purchasing shares as a hedge. Nonetheless, the short party can hedge through other means such as entering into a back-to-back equity swap with another entity. As suggested by the FSA, "[there is no] clear evidence whether [contracts for differences] held as pure *economic interests* – i.e. with no intention to link to the voting rights - can create problems of inefficient price formation".[46] Thus, without an express agreement to this effect, we cannot assume that equity swaps always pose a threat to corporate governance and market efficiency.

Second, because equity swaps tend to be used as short-term instruments, problems of empty voting or hidden ownership may be temporary. If there is no general meeting held during the life of a swap, it is arguable that no such problem arises at all. In addition, if the short party uses the swap as a hedge and plans to hold the shares for the longer term, the incentives for misaligned empty voting might not exist.

---

[41] *Ibid*, 138.
[42] *Ibid*, 148-157.
[43] *Ibid*, 171-172.
[44] T Frankel, "The New Financial Assets: Separating Ownership from Control" (2010) 33 *Seattle University Law Review* 931, 940.
[45] FSA, FSA, *Consultation Paper, Disclosure of Contracts for Differences* (CP 07/20), 3.23 and Chapter 4.
[46] *Ibid*, 3.16.

Third, one might argue that a full disclosure system could have a chilling effect on other swap transactions. However, this argument is less persuasive, as mandatory disclosure is triggered only above a certain threshold.[47]

(B) PRIVATE ORDERING VS MANDATORY DISCLOSURE

On this basis, a further issue concerns the source of the duty of disclosure, if any. There are two competing approaches: private ordering and mandatory disclosure. By private ordering, parties can use a contract to deal with potential problems. Private ordering may be more flexible than mandatory disclosure.[48] In the context of company law, it is possible that directors or existing shareholders might amend the company's memorandum or articles of association to require mandatory disclosure. After all, articles of association are deemed a statutory contract between members *inter se* and between the company and its members.[49]

Under the private ordering approach, a member can avoid disclosure under the articles only if he owns no shares in the company. In *Ithaca* and *CSX*, the long parties to the swaps both maintained certain shareholdings below the statutory disclosure threshold before unwinding the swaps. Thus, this approach might reduce the surprise factor seen in *CSX*, though it might not ultimately prevent a third party from mounting a takeover bid.

However, amending the articles of association is easier said than done. First, there could be considerable costs attached to proposing a new resolution to alter the articles given that a special resolution is required under Singapore law.[50] Second, an amendment to the articles, if approved, might only help address future problems and may be too late to deal with an imminent threat. Moreover, any attempt to alter the articles might alert a potential bidder and result in the battle commencing earlier than expected. Thus, the effectiveness of this approach is doubtful.

Furthermore, the management or existing shareholders might have incentives to propose that the articles be altered for their own benefit.[51] A long party might argue that such alteration is not "*bona fide* in the interest of the company as whole".[52] However, the common law seems to take a more subjective approach on the issue of "good faith".[53] The legal position in Singapore seems to

---

[47] Bertaccini, *supra* n 21, 289-290.

[48] Donahue, *supra* n 21, 253-255.

[49] CA s 39(1).

[50] CA s 37.

[51] Hu and Black, Empty Voting I, *supra* note 3, at 891.

[52] *Allen v Gold Reefs of West Africa, Ltd* [1900] 1 Ch 656 (CA); *Greenhalgh v Arderne Cinemas* [1951] Ch 286 (CA).

[53] *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9 (CA); *Citco Banking Corp NV v Pusser's Ltd* [2007] UKPC 13.

be the same.[54] Therefore, as long as existing shareholders can prove their honesty in voting for a resolution to alter the articles, the courts are less likely to intervene. Thus, potential bidders will not find it easy to challenge any amendment of the articles requiring bidders to disclose indirect economic interests in the company's shares, even if there is a potential conflict of interests.

Another possible choice for the target company is to go private. Under Singapore law, private companies must impose certain restraints on the transfer of shares.[55] Therefore, with well-designed restraints on the transfer of shares, the board or a majority of members could fend off potential bidders with ease. However, this approach might also means delisting from the stock exchange if the company is a listed company in Singapore.

While private ordering does not seem to be a totally effective solution, mandatory disclosure is not without its problems. First, maintaining a mandatory disclosure system could involve considerable costs. In the UK, the FSA estimated that the cost of setting up a disclosure system for contracts for differences might be between ₤20-50 million, with ongoing maintenance costs of ₤1.5 million per year.[56] It may cost less in Singapore. However, the Monetary Authority of Singapore might have to deal with the disclosure of transactions executed in London, New York or any foreign country. This might then create an additional regulatory burden and leave some room for regulatory arbitrage.

Moreover, it is also questionable whether mandatory disclosure would be capable of addressing potential problems in this area. In the UK, the FSA also found that mandatory disclosure may not be effective in addressing problems of undisclosed voting rights if the short party has not purchased physical shares as a hedge or if the swap is not terminated at all, despite finding that mandatory disclosure may improve corporate governance and there might be a stronger case for mandatory disclosure in the market for corporate control.[57] In sum, the FSA was of the opinion that "[o]verall economic arguments would suggest that, for [equity swaps] disclosure to be valuable, it needs to be strongly linked with having access to the voting rights."[58]

(C) THE FUTURE FOR SINGAPORE

The foregoing discussion indicates there is no perfect solution. As suggested above, equity swaps may pose a threat to corporate governance and undermine market efficiency. However, the problems of empty voting and hidden ownership are not necessarily associated with all forms of equity swap trading. Assuming

---

[54] Tan, *supra* n 1, 135.
[55] CA s 18(1).
[56] FSA, *supra* n 45, 5.63.
[57] FSA, *supra* n 45, 4.6 (Box 2).
[58] *Ibid*.

that the *CSX* and *Ithaca* cases created a potential problem, the question then becomes how Singapore law should be reformed to address the "market reality"[59]. This question is worthy of exploration at three levels.

The first and easiest way is to modify the Code of Takeovers and Mergers. Though the SIC considered this problem in 2006, no proposal has yet been made to address this point. From a comparative law point of view, disclosure of the use of equity derivatives during a takeover offer is now mandated in the UK.[60] In Australia, a more stringent stance is adopted by the Takeovers Panel, which made clear that "[w]here there is a control transaction, the Panel would expect that all long positions which already exist, or which are created, are disclosed unless they are under a notional 5%."[61]

As discussed earlier, the SIC's current approach is hardly effective in avoiding the surprise factor seen in *Ithaca* and *CSX*. The Australian position could provide a blueprint for the SIC to consider in future. After all, given that takeover offers are all about acquiring control of the company, there is a case for strengthening disclosure requirements for dealings in securities of the offeror or offeree and the information provided in offer documents. The SIC could consider broadening the application of existing rules to include swaps or other derivatives in addition to options.

Second, it is arguable whether securities regulation in Singapore should address the problem of equity swaps for listed companies. The problems of empty voting and hidden ownership are most likely to occur to listed companies. From a comparative law perspective, UK law provides that disclosures on interests in shares acquired through "qualifying financial instruments" should include those on "options, futures, swaps, forward rate agreements and any other derivative contracts … provided that they result in an entitlement to acquire, on the holder's own initiative alone, under a formal agreement, shares to which voting rights are attached".[62] We should remember that UK law still focuses on an "entitlement to acquire" shares or voting rights, and thus does not require the full-scale disclosure of all equity swap positions.

Hong Kong seems to have the broadest equity swaps disclosure requirement. Revised in 2003, Section 310 of the Securities and Futures Ordinance (Cap 571) requires the disclosure of interests in the shares of a listed company in Hong Kong. Section 311(2) further explains that

---

[59] See *supra* section B.2.(c).

[60] City Code on Takeovers and Mergers, Rule 8 Note 5(i).

[61] Australia Takeovers Panel Guidance, Note 20 at [9] in <http://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=guidance_notes/current/020.htm&pageID=&Year=> (accessed 8 February 2011).

[62] FSA Handbook 5.3.2(1)R.

> an interest in shares … includes a reference to interests in shares so comprised, which are the underlying shares of equity derivatives, that a person has, or ceases to have, by virtue of-
>
> (a) the holding, writing or issuing by him of the equity derivatives;
> (b) the exercise by, or against, him of rights under the equity derivatives; or
> (c) the assignment by him, or the lapsing without exercise, of rights under the equity derivatives.

Overall, the problem is where the "market reality" stands. As suggested by *CSX* and *Ithaca*, the effects of empty voting and hidden ownership are most likely to be seen when the short party purchases voting shares. Legislators might consider abandoning the use of the word "right" or "authority" in section 4 of the SFA to reduce rigidity and offer more flexibility to accommodate financial innovation. Second, whether there must be a universal disclosure system for long parties holding economic interests in Singapore listed companies is debatable. Further regulatory impact analysis is required to identify relevant costs and benefits.

Moreover, there could be other ways of regulating the use of equity swaps apart from mandatory disclosure by the long party, as the effects of empty voting and hidden ownership are more obvious when the short party purchases physical shares as a hedge. For example, the law might require short party financial institutions to disclose positions in equity swaps for which they hold shares as a hedge. This might not be as complete a solution as full disclosure, but it might provide some useful information to the market without the trouble of establishing a full mandatory disclosure system.

The third and most general level at which potential Singapore law reforms should be considered is the Companies Act. We have not found any examples of other countries requiring mandatory disclosure under general company law. This shows that equity swaps are more commonly used for listed companies, in which greater liquidity allows the "market reality" to operate.

However, this does not necessarily mean that empty voting and hidden ownership will never occur to unlisted companies; there is still a potential threat to corporate governance and market efficiency among such companies. However, the sheer number of unlisted companies and the potential cost of imposing a disclosure obligation might be too high to justify the benefits that would accrue.

Thus, private ordering seems to offer a better solution at the Companies Act level. Singapore lawmakers might wait for market participants to develop their own tactics before making any response. Alternatively, Singapore might

revise Table A,[63] the default set of articles of association, to include a disclosure requirement for equity swaps in the next round of corporate law reform.

In sum, this article argues that Singapore lawmakers might respond to the *CSX* and *Ithaca* cases through a mixed set of actions. On the one hand, there seems to be greater demand for changes to be made to the Takeover Code to clarify the duties of relevant parties during takeover offers and strengthen the SIC's powers. On the other hand, revising the SFA for listed companies requires further regulatory impact analysis. We should also be aware that other regulatory tools might be used to deal with the same problem. On the most general company law level, this article argues that private ordering is the preferred solution for the time being.

D. THE USE OF EQUITY SWAPS BY THE MANAGEMENT OR THE COMPANY

This section further explores some legal issues arising from the use of equity swaps by company directors or the company itself.

1. DIRECTORS AS A LONG PARTY

Several issues arise when a director takes a long position in an equity swap referencing the shares of the company he serves. First, there are issues concerning disclosure of the director's shareholding. Pursuant to section 164 of the Companies Act, directors must disclose their interests in the company's shares or debentures (including options).[64] However, an "interest in shares" under section 164 is also defined by reference to section 7 of the CA. Thus, there is the same issue of construction discussed above.

In addition, a director must also disclose to the company the particulars of "contracts to which the director is a party or under which he is entitled to a benefit".[65] While it is arguable whether a director is "entitled to a benefit" as the long party to an equity swap, such "entitlement" is qualified by "being contracts under which a person has a right to call for or to make delivery of shares in the company".[66] Therefore, a literal reading suggests that there is no duty to disclose if there is no agreement of any kind allowing the director to call for delivery of the shares.

---

[63] Fourth Schedule of the CA.

[64] CA ss 164(1)(a) and 165(1)(a). A director also has to disclose his 'participatory interest', defined as a reference to a unit in a collective investment scheme or in the debentures of a company. CA ss 164(1)(b), 165(1)(a) and 165(6)(a).

[65] CA s 164(1)(d) and s 165(1)(a).

[66] *Ibid*.

Second, a director might breach his fiduciary duties by entering into an equity swap as the long party. In Singapore, "[a] director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office".[67] Directors owe a duty of undivided loyalty to the company and should not profit from their office or put themselves in a position whereby their duties and interests may conflict.[68] Thus, directors should not profit from their office.[69] Violation of the no-conflict and no-profit rule may lead to disgorgement of profits or compensation of damage, and even criminal charges.[70] Directors who encounter a conflict of interests in a takeover bid must consult the Securities Industry Council on whether it is appropriate for them to perform their responsibilities in recommending the offer.[71] Issues of insider dealing could arise if a director enters into an equity swap before a piece of material information is disclosed to the public.[72]

By entering into an equity swap as the long party, a director will gain from the success of the company he manages (assuming the share price goes up or dividends are distributed). This situation is comparable to writing a call option in favour of a director. While it is arguable that there is no obvious conflict of interest, a director could still profit from his office. Though it has yet to be confirmed by the courts, this article argues that there is a substantial likelihood of directors breaching their fiduciary duties unless such transactions are disclosed and approved by the company.

Two further academic notes on a director's position as a long party can be added. First, it is arguable whether section 164 of the Companies Act should be interpreted in the same way as provisions dealing with the disclosure of substantial shareholdings. Both directors' shareholding disclosures and substantial shareholding disclosures hinge upon the interpretation of section 7 (interest in shares).[73] However, section 164 does not specify any threshold for the disclosure of a director's shareholding, while the barrier for substantial shareholders is 5%. Given that disclosure of a director's shareholding has a much more direct impact on transparency and corporate governance, there is a stronger argument for requiring mandatory disclosure of directors' equity swap exposures. For this

---

[67] CA s 157(1).

[68] *Bristol and West Building Society v Mothew* [1998] Ch 1 at 16 (CA) (*per* Millet LJ); *Chua Boon Chin v JM McCormack* [1979] 2 MLJ 156, 158 (High Ct, Singapore).

[69] *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134 (HL); *Hytech Builders Pte Ltd v Tan Eng Leong* [1995] 1 SLR(R) 576 (High Court, Singapore).

[70] CA s 157(3); *Lim Weng Kee v Public Prosecutor* [2002] 2 SLR(R) 848 (Court of Appeal, Singapore).

[71] Rule 6.2 of the Singapore Code on Takeovers and Mergers.

[72] SFA ss 218-219.

[73] CA s 7(1).

purpose, it worth considering whether it is necessary to tie both sections 82 and 164 to the same definition in section 7.

Second, can equity swaps be regarded as another form of directors' remuneration? Section 169 of the CA requires that a director's emolument must be approved by a separate resolution in the general meeting.[74] As noted earlier, equity swaps may be used to create synthetic shareholdings. Thus, a cleverly devised scheme may allow a director to gain from proper management of the company in a manner similar to that provided by share options. At a time when executive pay is under heavy scrutiny in the Western world, it may be worth keeping an eye on whether equity swaps have been or will be used to as an alternative form of directors' remuneration, and whether such arrangements might fall within the ambit of section 169.

2. DIRECTORS AS A SHORT PARTY

Issues concerning the disclosure of shareholdings and fiduciary duties will also arise if a director takes a short position in an equity swap. The disclosure issue has been discussed above. The conflict of interest is much greater if the director is the short party. Because he will gain from the company's failure, he has an incentive to mismanage the company's business, so his personal interest (in the swap) conflicts with that of the company. This also means that directors cannot hedge the shares they own unless their holdings are disclosed to and approved by the company in advance.

3. THE COMPANY AS A LONG PARTY

We may further explore the situation in which a company enters into an equity swap referencing its own shares, as seen in the *Sino-Env* example discussed above.[75] It is also not unthinkable that a director or an existing shareholder might cause a subsidiary company to build up its economic exposure to the shares of a holding company to fend off a takeover offer.

There is no specific rule in the CA or the SFA prohibiting companies from acquiring pure economic interests in their own shares as a long party. However, where the short party does purchase company shares as a hedge, it is arguable whether the company ("X") would violate the financial assistance rule for the purpose of capital maintenance.[76] Section 76(1) of the Companies Act states that

---

[74] The term "emolument" includes "fees and percentages, any sums paid by way of expenses allowance in so far as those sums are charged to income tax in Singapore, any contribution paid in respect of a director under any pension scheme and any benefits received by him otherwise than in cash in respect of his services as director." Section 169(2) of the CA.

[75] See *supra* section B.2.(a).

[76] The financial assistance rule in Singapore traditionally refers to the function of capital maintenance. *See Public Prosecutor v Lew Syn Pau* [2006] 4 SLR(R) 210, [79]-[80]. However, it

Except as otherwise expressly provided by this Act, a company shall not —

(a) whether directly or indirectly, give any financial assistance for the purpose of, or in connection with —

(i) the acquisition by any person, whether before or at the same time as the giving of financial assistance, of —

(A) shares or units of shares in the company; or

(B) shares or units of shares in a holding company of the company; or

(ii) the proposed acquisition by any person of —

(A) shares or units of shares in the company; or

(B) shares or units of shares in a holding company of the company; …

The question is whether the combination of equity swaps and the market reality constitutes "financial assistance", and whether an equity swap is executed "for the purpose of" or "in connection with" acquisition of the company's shares (or those of a holding company). The test is whether "the assets of the company had in fact been used or been put at risk for the purpose of the intended acquisition".[77]

It is arguable whether the company (as the long party) "financially" assists the short party in acquiring the company's shares. In the case of equity swaps, there is a cash flow from the long party to the short party calculated according to the interest rate defined in the contract.[78] Such a payment does not mimic a loan, a guarantee, the provision of security, or release of an obligation.[79] Thus, one might argue that there is no "financial" assistance at all.

However, as English courts have decided, the company acquiring assets from its counterparty might still amount to illegal financial assistance if the asset purchase gives the counterparty funds to acquire the company's shares.[80] For the same reason, such a situation could amount to illegal financial assistance if the short party uses money paid under the swap to purchase the reference shares. After all, some money has been transferred from the company (as a long party) to the short party under an equity swap.

---

is questionable whether the financial assistance rule helps to maintain the capital of a company. Tan, *supra* n 1, 488-489.

[77] *Public Prosecutor v Lew Syn Pau* [2006] 4 SLR(R) 210, [88] and [125] (Court of Appeal, Singapore).

[78] Under Singapore law, the assistance must be 'financial' in nature. *Ibid*., [183]-[186].

[79] CA s 76(2).

[80] *Belmont Finance Corp Ltd v Williams Furniture Ltd (No 2)* [1980] 1 All ER 393 (CA).

In addition, the price paid for an equity swap may be quite substantial. For example, in the *Sino-Env* transaction, the price paid for the swap was S$67 million, about 45% of the sum received from the company's convertible bond issue.[81] Moreover, short parties do not necessarily purchase the full amount of reference shares. It might so happen that the short party acquires only some of the reference shares as a hedge. In this instance, the sum paid by the long party might be enough to cover the cost of the acquisition of physical shares.

Furthermore, while it is arguable whether an equity swap is executed for the purpose of acquiring the company's shares,[82] such a transaction is likely to be "in connection with" the acquisition of shares, if the company knows that the counterparty will purchase physical shares.[83] Whether an equity swap is "for the purpose of" or "in connection with" a short party's purchase of a long party's shares still depends on the facts of a case. However, if, as in *CSX* or *Ithaca*, the long party knows before entering into the swap that the short party will purchase the company's shares at a later date, it might be more difficult for a company to argue that such a transaction is not for the purpose of or in connection with a share acquisition.

In sum, depending on the facts, it is possible that a company might breach the financial assistance rule by entering into an equity swap referencing the company's own shares if the short party purchases physical shares as a hedge. Though no one seems to challenge the effect of the *Sino-Env* transaction in Singapore, this is a risk the company and its management have to consider.

4. THE COMPANY AS A SHORT PARTY

There is little problem with the company being the short party to a swap referencing its own shares. Two issues are worthy of brief exploration. First, such an arrangement allows the company to hedge the market price of its shares if a fall in the share price would otherwise cause the company to suffer a loss. This might happen, for example, when the company's stock includes treasury shares.

An academic question then arises: whether a company can speculate on its own share price falling if an equity swap is not properly associated with losses the company might suffer. There is no problem if the company is in the money.

---

[81] See http://info.sgx.com/webcoranncatth.nsf/VwAttachments/Att_EBB1506F89EC5E2D4825745D0071098B/$file/4_Jun_2008_Press_Release_FINAL.pdf?openelement, accessed on 3 March 2011.

[82] CA s 76(3).

[83] S 76(4) of CA states that "a company shall be taken to have given financial assistance in connection with an acquisition or proposed acquisition referred to in subsection (1) (*a*) if, when the financial assistance was given to a person, the company was aware that the financial assistance would financially assist … the acquisition by a person of shares or units of shares in the company …"

Nonetheless, there could be potential problems if the company ultimately suffers a loss on such a transaction.

Second, if properly structured, equity swaps can be a form of off-balance sheet financing. We might learn a lesson from local authority cases regarding interest rate swaps in the UK in the 1990s. For example, in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*,[84] the interest rate swap employed a deep discount structure where the fixed-rate payer (a bank) made a lump sum payment to the local council at the start of the transaction. The council's payment obligation then depended upon the relationship between the fixed rate and the market floating rate. In a way, the swap provided the council with a form of financing.[85] A properly structured equity swap might produce a similar result whereby a company (as the short party) receives a cash sum at the beginning of the transaction. How far this form of financing may progress remains to be seen, and will be driven by the innovation of market participants.

E. CONCLUSION

This article argues that equity swaps might have profound implications for company law. By enabling counterparties to acquire economic interests in a company's shares, such instruments could lead to problems of empty voting and hidden ownership, resulting in concerns about corporate governance, transparency, and market efficiency. Several legal issues might arise in Singapore.

As shown in the *Ithaca* case in New Zealand and the *CSX* case in the US, equity swaps are capable of being used as a tool to compete for corporate control. The issue of most immediate concern relates to the disclosure of substantial shareholdings. This article argues that the language employed in Singapore law is limited to accommodate the acquisition of economic interests in shares via equity swaps. To address potential problems, Singapore might consider revising the Takeover Code. However, further regulatory impact analysis is required before any revision of the Securities and Futures Act and the Companies Act. As an alternative, companies can always use their articles of association to impose a contractual duty of disclosure before statute law intervenes.

If directors take long or short positions in equity swaps, not only could directors' shareholding disclosure issues arise, but they could breach their fiduciary duties. This article proposes that the statutory duty under section 164 of the Companies Act be broadened to cover swap trading on the part of directors. In addition, companies might also take long or short positions in equity swaps, in

[84] [1996] AC 669 (HL).

[85] See *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1 (HL); *Morgan Grenfell & Co Ltd v Welwyn Hatfield District Council* [1995] 1 All ER 1 (QB).

which case the biggest concern might be potential breach of the financial assistance rule. This is a point requiring future clarification from the courts.

It remains to be seen how far empty voting and hidden ownership via equity derivatives and the effect of separating risk from share ownership impact corporate practice and company law. Equity derivatives will not disappear from the market. There is no limit to human creativity in the world of financial derivatives until the point where the law sets a boundary.