

Potential Canadian implications of the Archegos fallout

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Global bank losses following the Archegos Capital Management (Archegos) fallout have now surpassed \$10 billion, prompting renewed focus in the U.S. on disclosure requirements relating to ownership of public securities and related derivatives. Archegos is believed to have used a type of derivative called a total return swap in order to take leveraged, concentrated positions in a number of companies. These positions were unwound following margin calls, resulting in downward pressure on a number of blue-chip stocks and substantial losses to a number of banks that were counterparties to Archegos' swaps and unable to recover funds from Archegos. On May 6, 2021, Securities and Exchange Commission (SEC) Chairman Gary Gensler indicated that the SEC will consider regulatory changes in response to this March 2021 liquidation of Archegos' substantial stock positions. It will be interesting to see if a renewed focus on these issues in the U.S. leads to any corresponding review or changes in Canada.

Derivative instruments raise significant policy issues for securities regulators, including "hidden ownership" and "empty voting" concerns.^[1] In Canada, concerns regarding the use of derivative instruments have primarily arisen in the context of early warning reporting requirements. The Canadian Securities Administrators (CSA) considered, but ultimately rejected, increased reporting requirements for derivatives in the [May 2016 amendments](#) to the early warning reporting regime. Notably, at the time the CSA also decided not to proceed with their original proposal to reduce the early warning reporting threshold from 10% to 5%. However, Ontario's Capital Markets Modernization Taskforce (the Taskforce) recently [recommended](#) [PDF] lowering the disclosure threshold from 10% to 5% for "non-passive investors" (but did not address derivatives and hidden ownership).

Background

Canadian securities laws currently impose early warning obligations relating to the acquisition of securities of public companies. When a purchaser, other than an eligible institutional investor, acquires beneficial ownership or control or direction over 10% or more of a class of voting or equity securities, the purchaser is required to promptly issue and file a press release and, within two business days, file an early warning report containing prescribed disclosure with securities regulators. Further, the purchaser is subject to a "cooling off period" and prohibited from acquiring any securities of the relevant class until the expiry of one business day after filing the report.^[2]

The U.S. beneficial ownership report on Schedule 13D – the U.S. counterpart to the Canadian early warning report – triggers disclosure requirements at 5% ownership or control. Those requirements include the filing of a Schedule 13D report within 10 days of the trade date, in contrast with Canada’s near immediate press release requirement. Eligible institutional and passive investors may alternatively report on Schedule 13G, which permits even longer reporting timeframes. Additionally, the U.S. rules do not impose a trading moratorium except in limited circumstances, thus permitting the purchaser to acquire more securities of the relevant class well ahead of any public disclosure required to be made. Consequently, while the 10% reporting threshold in the Canadian regime appears more lenient and investor-friendly, for acquisitions in excess of 10%, the U.S. requirements can be far more favorable to an investor.

Both the U.S. requirements and the Canadian early warning regime were established to, among other things, increase transparency regarding material information for market participants. The reporting thresholds and corresponding disclosure requirements operate to signal to the market that a shareholder may be accumulating securities with the intention of changing or influencing control of the issuer. In both a Canadian early warning report as well as in a U.S. Schedule 13D report, for example, acquirors must disclose the purpose for acquiring the issuer’s securities, including plans or proposals regarding the issuer. Filers reporting on Schedule 13G in the United States must certify that they did not acquire and are not holding the securities for the purpose of or with the effect of changing or influencing control of the issuer.

Derivative Disclosure

The challenge of regulating the disclosure of derivative instruments is owed to their variety and complexity. In the case of Archegos, the firm is believed to have used a type of derivative called a total return swap, allowing it to leverage its investment and obtain substantial economic exposure to specific securities while not having to pay the full purchase price for such securities. Total return swaps have also been considered in the M&A context by acquirors seeking to replicate the economic advantages of acquiring a toehold position.

Total return swaps are agreements between two parties that allow one party to “swap” or trade places with another party with respect to the economic benefits of ownership of different securities. In other words, the parties agree to exchange the *total* economic returns of their respective underlying assets, which continue to be legally and beneficially held by each original holder. At the end of the swap, the total economic value of the ownership of each underlying asset during the period is measured and netted, with one party making a cash payment to the other party in the amount that would put both parties in the position they would have been in if each had owned the other’s underlying asset during the swap period. The underlying asset may be a bond, a basket of public securities, a loan or a specific equity interest. By way of example, a shareholder owning common shares of a public company may enter into a total return swap with a bondholder for a bond with an equivalent value earning interest at LIBOR plus 3%. During the swap period, the shareholder would be entitled to the interest earned on the bond during the period, while the bondholder would be entitled to the aggregate returns on the common shares during the period (capital appreciation and any income generated through dividends or distributions). At the end of the swap period, the bondholder would either make a cash payment to the shareholder, or the shareholder would make a cash payment to the bondholder, to put each in the economic position they would have been in if each were the owner of the other’s asset.

One advantage of a swap is to separate the risk of ownership from actual ownership. In this example, the shareholder retains ownership of the underlying public company common shares and transfers the risk associated with a decrease in the value of the common shares to the bondholder. Consequently, and assuming there is no credit risk with the investor, the

shareholder stands to earn a LIBOR plus 3% return during the period, with the bondholder bearing the risk of the stock price going down. The bondholder, on the other hand, foregoes the LIBOR plus 3% interest income on the swapped bonds it owns, in exchange for the right to receive the benefit of the stock price going up (plus any dividends or other distributions on the stock during the period). As with any financial instrument, the parties to a total return swap are exposed to the risk that the counterparty may not be creditworthy or may become insolvent, in addition to the risks and rewards that each party assumes under the commercial terms of the swap.

This structure has two critical consequences: there is no transfer of ownership of either underlying asset to the swap counterparty; and a swap party may benefit from leverage in not having to pay the purchase price for the underlying asset in order to derive the economic benefits of ownership of that asset. This increased leverage may heighten market volatility and systemic risk.

Canadian and U.S. disclosure requirement frameworks are predicated on legal definitions of beneficial ownership and control. Cash settled derivative instruments such as a total return swap do not result in any change of legal or beneficial ownership of the underlying asset, despite transferring the real economic interest in that asset to the swap counterparty. As a result, hidden ownership and empty voting issues may arise.

Under the current Canadian rules, beneficial ownership reporting requirements are triggered on the basis of actual or deemed beneficial ownership of, or control or direction over, 10% or more of a class of voting or equity securities. Total return swaps, other derivatives and any other arrangement that is an economic equivalent to ownership, acquisition or disposition of shares of the same class must also be reported by the holder *after* the reporting threshold has already been triggered based on actual or deemed beneficial ownership, or control or direction over, securities. However, these economic equivalents to ownership are generally not currently taken into account for the purpose of calculating whether the reporting threshold is triggered to begin with. For example, a party may hold a greater than 10% economic interest in common shares of a public company through a number of total return swaps, but may not be subject to any reporting obligations in respect of that economic interest if it did not actually beneficially own, or have control or direction over, any securities of the same class. However, in determining beneficial ownership, or control or direction, over a security, investors must be mindful of guidance from the CSA that an investor that is a party to an equity swap or similar derivative arrangement may under certain circumstances have *deemed* beneficial ownership, or control or direction, over the referenced voting or equity securities where the investor has the ability, formally or informally, to obtain the voting or equity securities or to direct the voting of voting securities held by any counterparties to the transaction.

In 2013, the CSA proposed amendments to require investors to include “equity derivative positions” that are substantially equivalent in economic terms to conventional equity holdings in calculating their ownership levels when determining whether reporting obligations were triggered. However, based on comments from market participants, the CSA ultimately determined not to proceed with this proposal. Some of the concerns expressed at the time were:

- the potential detrimental or inadvertent impact of capturing equity derivative positions, such as hindering an investor’s ability to rapidly accumulate or reduce a large position and the signaling of investment strategies to the market;
- the complexity and difficulty of applying a new early warning reporting trigger in respect of equity equivalent derivatives; and
- the significant administrative and compliance burden associated with implementing

additional reporting obligations.

Conclusion

The Archegos situation highlights certain of the risks that hidden ownership and lack of disclosure of derivative instruments may pose to markets, as the concentrated positions that Archegos was able to gain exposure to were never publicly disclosed and their unwinding led to increased market volatility and downward pressure on the applicable stocks. However, the solution to this derivative disclosure predicament is not straightforward. Implementing more robust disclosure requirements would increase compliance costs and potentially harm market liquidity. With a renewed focus on these issues by the SEC and with the Taskforce having demonstrated a willingness to revisit certain amendments to the early warning regime, it will be interesting to see if there is any further review or change in Canada.

[1] “Hidden ownership” refers to the use of derivatives to achieve economic exposure to public companies while avoiding public disclosure and to exert influence over such companies and over shareholder votes on an undisclosed basis. “Empty voting” occurs when a holder of the voting right attached to a share has reduced or eliminated its economic interest in that share through the use of derivatives or securities lending arrangements while seeking to influence the outcome of a shareholder vote.

[2] Under Canadian rules, “eligible institutional investors” or “EIIs” may also make disclosure pursuant to the more permissive alternative monthly reporting (AMR) system. A key difference between the conventional early warning system and the AMR system is that while the conventional system currently requires the prompt issuance of a press release and the filing of an early warning report within two business days of a reporting trigger, the AMR system allows the reporting of ownership positions to be made on a monthly basis, with each filing due within ten days of the end of the month. Further, the trading moratorium on purchases of additional securities does not apply.