Responsible Investment… in the Derivatives Markets?

It's not the derivatives that are weapons of mass destruction; it's some of the companies referenced in those derivatives. The derivatives aren't spilling the oil, exploiting children or causing cancer. But can a derivative allow an investor to do something about those companies or does it just keep the investor on the side-lines?

This question matters because corporate engagement, increasingly a feature of voluntary ESG and stewardship policies, is about to become hard law in Europe. From 10 June 2019, the EU Revised Shareholder Rights Directive, which aims to promote effective stewardship and long-term investment decision-making, will be implemented at member state level. The new rules will require investment managers to have a corporate engagement policy or provide a clear and reasoned explanation of why they have chosen not to. This is not a straight option because opting-out is conditional on a reasoned explanation. Engagement policies are expected to cover shareholder engagement, dialogues with investee companies and the exercise of voting rights.

On the face of it, there is a tension here: on the one hand, there is a reorientation of the market towards corporate engagement as a means of implementing ESG and stewardship policies; and, on the other hand, corporate rights are not attached to swaps or other derivatives because under such transactions hedge funds do not acquire an ownership interest in the reference equity or bond. So, for those routinely using swaps but about to adopt an engagement policy, is it safe to go back into the water?

Lawyers will rightly start with the contract governing the swap. Where a hedge fund has long exposure under a swap transaction, its interest is contractual - its economic interest is not in the asset itself but in cash flows determined by reference to it. The terms of the swap will usually provide that (1) the dealer is not obliged to hold the underlying security and, if it chooses to do so, it does so for its own account and not as nominee or custodian for the hedge fund; and (2) the hedge fund has no right to vote the underlying security and only receives amounts "equivalent to" any dividends, not the dividends themselves. The second point invites the question "why not?"; the first supplies the answer.

Compared to investing in the security directly, are derivatives therefore a sub-optimal means of discharging forthcoming regulatory obligations to engage meaningfully with companies? Is investing in the security more empowering?

That is certainly the widespread assumption. But the grass is not necessarily greener for those holding the cash position. More than a decade after Lehman, a new generation of portfolio managers have little familiarity with the structural and contractual basis on which their portfolios are held.

Most securities in hedge fund portfolios are not directly held. Legal title (as recognised by the issuer) and equitable interest are divided. This duality of property is the distinguishing feature of the common law. These interests are then further distanced from each other through intermediated holding structures through which most dematerialised securities are now held.

The consequence? Despite what the portfolio manager might assume, the hedge fund has no direct relationship with the issuer. While today's courts in England have done their best to maintain a rational link between this modern reality and Victorian precedent, there remain various inconvenient consequences for hedge funds as ultimate account holders. In practice, it means that for the exercise of ownership rights, the hedge fund is dependent on various planets aligning.

For example, the hedge fund has to hope that, at the relevant time, its equitable interest has not been extinguished by the prime broker's re-use of the security; that it receives timely information about any corporate action, which may have to pass from the issuer through three or four tiers in the holding structure; and that there are no proxy-related issues. There is anecdotal evidence of difficult conversations between hedge funds and their prime brokers, who themselves are not in a direct relationship with the issuer, following missed corporate actions.

At the same time, swaps do not operate, at least in an absolute fashion, to keep hedge funds from the field of play. Some swaps on corporate bonds contain terms giving hedge funds the right to "express preferred outcomes" in connection with pending votes on the underlying asset, even if such terms are of questionable value. Looking beyond contractual terms, hedge fund managers often have dialogues with corporate issuers, notwithstanding that they only have a swap position. Corporates engage in the knowledge that the dealer's hedge effectively gives the hedge fund an option to "flip" to the physical position if it so chooses.

Swaps present clear challenges to an engagement policy, but taking a cash position in the underlying security does not necessarily represent a problem-free alternative.

If you require advice on this new regulatory regime, or if you wish to discuss these matters in more detail, please contact your relationship partner or Dan Harris at daniel.harris@chanceryadvisors.com.

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