



International Swaps and Derivatives Association, Inc.

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BY HAND

Securities and Futures Commission
12th Floor, Edinburgh Tower
The Landmark, 15 Queen's Road Central
Hong Kong

Attention: the Secretary to the Securities and Futures Commission

Dear Sir/Madam,

The International Swaps and Derivatives Association, Inc. ("**ISDA**") is pleased to submit this comment letter to the Securities and Futures Commission (the "**SFC**") in response to its Consultation Paper on Amendments to the Securities (Disclosure of Interests) Ordinance (the "**Ordinance**") published in June 1998 (the "**Consultation Paper**").

ISDA is an international organisation whose membership comprises over 360 of the world's largest commercial, merchant and investment banks, corporations, governmental entities and other institutions. ISDA's members represent a broad cross-section of the institutions that are dealers in and end-users of privately negotiated derivatives ("**over-the-counter**" or "**OTC**" derivatives) both in Hong Kong and world-wide. A recent list of ISDA's members is attached as an Annex to this letter.

As you are aware, the growth in the use of OTC derivatives has been instrumental in reducing risks arising from traditional commercial and financial activities. OTC derivatives have increased opportunities for risk-sharing whilst allowing for lowering of transaction costs. Their use in corporate finance and as trading, investment and risk management tools, has grown substantially over the last decade. A survey by the Bank for International Settlements in March 1995 indicated that the total notional value of derivatives outstanding was US\$14,475,702,000,000.

I. Introduction: Proposals for Derivatives

The Consultation Paper proposes that the issue, acquisition, disposal and exercise of derivative instruments on listed shares by a substantial shareholder should be declared to the relevant company and The Stock Exchange of Hong Kong Limited (the "**Stock Exchange**"). It states that:

"SFC enquiries suggest that OTC derivatives dealings by substantial or controlling shareholders have a significant influence on trading in many listed companies with smaller market capitalisation in Hong Kong and provide the explanation for changes in price and volume which are otherwise unexplained. In the interests of transparency and of deterring manipulative conduct the SFC believes that it is essential that the derivatives dealings of substantial shareholders be fully declared to the market in a timely fashion."

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ISDA is concerned about the effect of the proposals contained in the Consultation Paper on OTC trading in equity derivatives. ISDA believes any new disclosure requirements must help to achieve greater transparency in the underlying equity markets whilst ensuring that the amount and type of information to be disclosed does not impede liquidity in the OTC markets by imposing onerous obligations on investors wishing to deal in OTC equity derivatives. ISDA has the following specific concerns:

- conformity with international standards;
- the complexity of calculations of economic interest in respect of cash-settled and structured OTC derivative transactions; and
- the proprietary nature of information to be disclosed.

II. International Standards

ISDA notes that there are currently no disclosure requirements for purely cash-settled derivatives under the laws of the United Kingdom (the “UK”), the United States or Australia even though there has been significant growth in the trading of such products in these jurisdictions over the past few years.

The Securities and Investments Board (“SIB”) in the UK published a report in June 1995 which contained a proposal for requiring the disclosure of certain economic interests in the share capital of UK listed companies. The SIB stated in the report that it considered the disclosure of contracts for differences (that is, purely cash-settled derivatives such as an equity swap) to be of informational value to the market, as they represented economic, if not proprietary, interests in a company's performance. Accordingly, the Market Conduct Regulators Group of the SIB recommended that there should be disclosure of such economic interests if the aggregate of the economic and direct interests of a party exceeded a certain threshold in respect of the share capital of the listed company.

It is important to note that the recommendation by the Market Conduct Regulators Group of the SIB was put forward only in respect of institutions authorised under the Financial Services Act 1986 in relation to contracts for differences entered into by such bodies, rather than in respect of such contracts entered into by the general public.

It is also important to note that the SIB eventually decided not to impose any disclosure requirements on contracts for differences as a result of conceptual and practical objections to requirements of the type described in this letter.

III. Physically and Cash-settled Transactions

An OTC derivative may be physically-settled or cash-settled. If a transaction is physically-settled this will involve a transfer of a specified amount of the underlying equity at maturity. If a transaction is cash-settled this will involve a payment of differences at maturity, whether calculated on a single date or over a specified period of time.

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ISDA notes in relation to physically-settled transactions that, given the delivery requirement, it is usually clear what number of shares has to be delivered, and therefore, the extent of the economic interest in the underlying can easily be identified.

Although not expressly discussed in the Consultation Paper, it is understood that the SFC wishes to extend the current definition to include cash-settled derivative transactions. The current definition of a notifiable interest in shares is contained in Section 13 of the Ordinance. This does not include any cash-settled derivative transactions, because Section 13(5) only extends to transactions involving a delivery of shares or which involve the transfer of an interest in the shares. ISDA notes that the Consultation Paper suggests (on page 10) an extension of the definition of 'interest in shares' to include an 'economic interest in shares'.

The 10% disclosure rule currently contained in the Ordinance (like the comparable rules in the United States and the UK) was designed to enable a company to ascertain who exercises control, by means of votes attaching to shares, over its affairs. ISDA does not therefore think that it is necessary or desirable from a regulatory standpoint to extend the rule (or any lower disclosure requirement) to cover disclosure of pure economic interests which have no direct bearing on the concentration of voting rights and, as such the issue of control. Indeed the 10% disclosure requirement was never intended to apply to pure economic interests. A cash-settled OTC derivative does not give a counterparty any control over the underlying shares or the issuer of those shares.

Moreover, the simplest way to calculate the economic interest of a party to an OTC derivative transaction is to look at the hedging activity of its counterparty. ISDA notes that most (although not all) hedging activity will involve the acquisition and sale of an amount of the underlying equity or a related product (such as a listed future). ISDA notes that the current legislation requires the disclosure of any significant hedging activity by the counterparty in most circumstances.

The Consultation Paper states (on page 8) that:

“the market would likely perceive the price of a company’s securities differently if a shareholder or director holding 60% of the company’s issued shares also holds a put option over the same shares exercisable by him at a particular price or price range.”

However, it is likely that the counterparty will seek to take a short position on the shares so that if the put option is exercised, the counterparty can use the shares put to it to fill the short position. One way of doing this would be for the counterparty to enter into an agreement to borrow shares and then immediately sell them, returning the put shares to the lender. The premium paid by the substantial shareholder for the put option will largely be based on the anticipated cost to the financial institution of this hedging activity.

The physical selling of shares by the counterparty will be a factor affecting the market price of those shares. If (in contrast to the above transaction) the hedging activity involves an acquisition of shares, that acquisition would itself give rise to a disclosure requirement, to the extent the total number of shares held is in excess of the relevant thresholds. ISDA therefore disagrees with the inference that knowledge of a cash-settled transaction will never be available to the market under the current rules.

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IV. Index-linked and Basket Transactions

Equity derivatives have traditionally existed in the form of equity options and convertible securities developed as a means for providing capital raising opportunities for corporations as part of customised financing strategies which focus on individual stocks. However, more recently, these have been dwarfed by the growth in the market of equity derivatives related to baskets of shares and equity indices which are directed primarily towards investors/portfolio managers rather than corporations. Equity index linked derivatives are derived from equity market indices and are generally utilised to simulate an exposure to the relevant market as a proxy for direct investment in that market. By their nature, these transactions are likely to be cash-settled transactions and the points made above with regard to cash-settled transactions are equally relevant here.

The Consultation Paper discusses disclosure in respect of derivatives relating to single shares only. ISDA notes that, if a similar method is applied in respect of baskets of shares or index-linked transactions, the obligation to make the appropriate calculations for disclosure may prove even more onerous. This will particularly be the case if the performance of the derivative is partly calculated by reference to the best or worst performing of the shares in the basket.

Information in respect of index-linked and basket transactions, due to the non-specific nature of such products, should have no significant impact on the value of any one single stock component and such transactions cannot easily be used to manipulate the prices of individual component stocks. ISDA therefore believes that such transactions should be exempt from any disclosure obligations imposed on derivatives relating to single shares.

V. Structured Transactions

To the extent that disclosure requirements are imposed with respect to cash-settled transactions, ISDA is also concerned that such disclosure requirements must be clear about how to calculate the economic interest in the underlying shares and must be consistent in the way different legal and economic structures are affected.

The majority of equity derivatives are relatively straight-forward. However, due to the fact that OTC derivatives are privately-negotiated transactions they allow financial institutions and end-users to package together or unbundle different risks to suit the needs of each counterparty. Some transactions can therefore be highly complex and it may be difficult to determine the value of the economic interest in the underlying.

For example, pay-outs under an OTC derivative may be subject to certain conditions. There may be a floor below which no payments would be made, or a cap above which no payments would be made. Such a barrier would 'knock-out' any obligation to make a payment which would otherwise have arisen if the movement in the underlying had not breached the barrier. In this case the underlying risks are a combination of any movement in the reference asset/risk (such as a share or index) and also the volatility of movement in the price or level of that underlying. The economic interest in the underlying equity will vary depending on the interaction of these two factors.

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Although these may be the minority of transactions, any requirement in relation to cash-settled transactions must produce results that are consistent with the treatment of physically-settled transactions and the treatment of leveraged and more exotic products must also be consistent with the treatment of less structured products. In respect of the method of calculation of the economic interest in the underlying shares, it must be clear to market participants what criteria to apply to which transactions. ISDA notes that Specific Note 4 to the draft Form 2 (attached as Appendix 2 to the Consultation Paper) simply refers to the number of underlying shares to which a derivative relates. In summary, ISDA considers that it would be extremely complex and quite burdensome to require disclosure in respect of structured and exotic trades. Furthermore, given the complex nature of the disclosure that would have to be made in respect of such transactions, it seems very doubtful that disclosure would promote market transparency.

VI. Aggregation of Derivative Interests

ISDA does not agree with any of the three options proposed by the SFC in relation to the aggregation of derivative interests (on page 45 of the Consultation Paper). ISDA supports Option 1 to the extent that no alternative is available. If the disclosure of economic interests is required, ISDA believes that a person with an economic interest in shares should be able to aggregate and net all such interests when calculating whether it is required to make any disclosure. ISDA notes that in relation to the position of a lender under a stock borrowing agreement the SFC appears to take the view that the appropriate interest for disclosure is the net interest.

If no netting is allowed, then different legal structures will be treated differently even though each structure may have the same or a similar economic effect. The disclosure of gross long and short positions held by an investor is both onerous and unnecessary, and does not represent any additional informational value which is not represented by a net position. It would be particularly onerous to impose an obligation on a large financial institution to disclose the gross positions taken by each trader: such information would prove cumbersome to manage and the provision of such information would necessitate systems changes at a time when financial institutions are already facing the substantial systems challenges presented by European monetary union and the millennium date change issues. The netting of long and short positions held by a financial institution is permitted for capital purposes and ISDA believes that a similar stance should be taken for disclosure purposes.

ISDA does not agree with the SFC's proposal that a net short position should be discloseable because it is not clear that disclosure of such a position is of informational value to the market.

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VII. Disclosure of Changes in the Nature of a Derivative Interest

The SFC has also proposed legislation to make clear that any change in the nature of a director's interest is required to be disclosed and also separately that this be extended to the interests of any substantial shareholder. Therefore, if a substantial shareholder purchases a physically-settled call option on shares, and then exercises that option to acquire those shares, this change in the nature of the substantial shareholder's interest would be discloseable. Because a change in the nature of a derivative interest, whether resulting from an exercise or expiry or otherwise, without a change in the percentage of share interest, does not represent a change in the economic interest, ISDA believes that the burden of such disclosure by any person (other than directors and chief executives) would greatly outweigh any possible benefit such disclosure may have on price adjustment in the market.

VIII. Information to be Disclosed

ISDA notes that disclosure requirements require the parties to place proprietary and often confidential information in the public domain. ISDA believes that any such requirement must therefore take into account the balance between the need to protect markets and investors and the rights of individual market participants.

The SFC is proposing that substantial shareholders disclose the consideration paid or received by them when dealing in interests in shares and the terms of any off-exchange agreement. ISDA is particularly concerned that the requirements relating to the disclosure of consideration and agreements will have a significant impact on the competitive position of individual market participants, if these requirements extend to cash-settled derivatives. Only a limited number of jurisdictions have a requirement that consideration and the terms of any agreement be disclosed, and none of those jurisdictions require such disclosure in respect of cash-settled derivative transactions.

ISDA also believes that in many instances it may be difficult for a substantial shareholder to disclose the amount of such consideration. A financial institution entering into an OTC derivative transaction with a professional market participant will not (and is not otherwise required to) disclose to a counterparty the profits and commissions that are made from entering into that transaction. Such a requirement would be inappropriate in what are effectively wholesale financial markets. By imposing a requirement to disclose consideration paid or received in relation to equity derivatives the SFC will fundamentally alter the commercial relationship between the counterparties.

ISDA also notes that by requiring a financial institution to put information relating to the terms of agreements into the public domain, the SFC is effectively requiring the disclosure of such information to competitors and also to future counterparties. It is clearly a concern that the potential commercial disadvantages of having to publicise information of this nature may discourage on and off-shore financial institutions from buying or selling exposure to Hong Kong shares.

Any disclosure requirement should take into account the way in which such information is used by the market. ISDA notes that, even if current proposals are adopted, information about the trading activities of substantial shareholders will not be disclosed to the market until two days later.

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IX. Disclosure of Share Pledges

ISDA supports the current position that banks are exempt from the disclosure requirements if shares are provided to them as security for a loan. ISDA proposes that a similar exemption be given to parties holding equity securities as security for an OTC derivative transaction or where title is transferred under another structure giving protection against the risk of a counterparty's default (such as ISDA's published form of English law Credit Support Annex).

X. Form 2

ISDA is pleased to comment on the sample draft notification form. ISDA supports the use of plain language by the SFC and believes that the draft Form 2 is relatively easy to use. However ISDA suggests that Paragraph 2(iii) be amended to reflect the fact that an off-exchange transaction may take the form of a bilateral agreement rather than the "acquisition" of an asset or an interest in shares. ISDA suggests that the term "transaction" is used.

ISDA also suggests that Paragraph 4 be amended. Paragraph 4 contains a list of different types of off-exchange transactions. However this list is not comprehensive and focuses mainly on different types of option. For example, there is no mention of swaps. ISDA suggests that the elections in Paragraph 4 be amended to focus on whether a derivative product gives a synthetic long or a synthetic short position without distinguishing between different legal forms.

XI. Conclusion

ISDA fully supports the objectives of the Consultation Paper, the prevention of market manipulation and insider dealing, and greater transparency for the equity markets. However ISDA wishes to highlight some of the issues which exist in respect of the imposition of a disclosure regime on OTC equity derivatives and which have not been fully addressed in the Consultation Paper. These are particularly acute in relation to cash-settled derivatives where it is considered that the potential for market manipulation is reduced and the calculations involved are likely to be complex. ISDA believes that the SFC should limit the scope of any reforms, taking into account practices in other jurisdictions.

A broad-based disclosure requirement will be difficult to administer. This will impose significant costs. In addition regulators and companies may find themselves overwhelmed with "information" that will be difficult to understand or interpret meaningfully. In ISDA's view disclosure requirements cannot be justified in the abstract, merely for reporting's sake alone. Parties to privately-negotiated transactions should not be required to divulge confidential proprietary information unless there are clear public policy reasons for doing so. ISDA does not believe there are such reasons.

ISDA is grateful for the opportunity to comment on the proposed amendments to the Ordinance and would be pleased to discuss the issues addressed above further or otherwise to assist in any way that the SFC may deem appropriate.

ISDA

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Yours sincerely,

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International Swaps and
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