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BY POST AND BY E-MAIL

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The Secretary to the Code Committee
The Panel on Takeovers and Mergers
10 Paternoster Square
London EC4M 7DY

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Dear Sir/Madam

Public Consultation Papers 2005/3 and 2005/4

The International Swaps and Derivatives Association, Inc. (ISDA)¹ thanks the Code Committee of the Panel on Takeovers and Mergers for the opportunity to comment on its Public Consultation Papers (PCPs) issued on 2 November 2005:

- (a) *Dealings in Derivatives and Options – Detailed Proposals Relating to Amendments Proposed to Be Made to the Takeover Code – Part 2: Control Issues* (PCP 2005/3); and
- (b) *Proposed Abolition of the Rules Governing Substantial Acquisitions of Shares* (PCP 2005/4).

We have previously commented in our letter of 28 February 2005 on *Dealings in Derivatives and Options – Outline Proposals Relating to Amendments Proposed to Be Made to the Takeover Code and the SARs* (PCP 2005/1) and our letter of 24 June 2005 on *Dealings in Derivatives and Options – Detailed Proposals Relating to Amendments Proposed to Be Made to the Takeover Code – Part 1: Disclosure Issues* (PCP 2005/2).

We have had the opportunity, during the course of our consultation within our membership and the preparation of this response, to review in draft form the response to PCP 2005/3 being prepared by the London International Banking Association (LIBA). Although our emphasis in this response is different in relation to certain issues (in light of our mission as the international trade association for derivatives), we would like to note that we are in substantial agreement with the views of LIBA on the questions raised by the Code Committee.

¹ ISDA is the trade association representing leading participants in the privately negotiated (or over-the-counter, “OTC”) derivatives industry. Its membership comprises more than 600 firms, including the world’s largest commercial, investment and universal banks, corporations, government entities and other interested parties. ISDA was chartered in 1985 and today represents institutions from 47 countries around the world. OTC derivatives include swaps, options and forwards on interest rates, currencies, commodities, equities and credit risk.

PCP 2005/1 proposed changes to the City Code on Takeovers and Mergers (the Code) and the Rules Governing Substantial Acquisitions of Shares (the SARs) relating to dealings in derivatives and options² in relation to a share during an offer period. The proposed changes dealt with both disclosure and control issues, and PCP 2005/2 set out detailed proposals in relation to the disclosure issues, resulting in the new rules relating to disclosure of dealings in derivatives and options set out in the Response Statement RS 2005/2 issued by the Code Committee on 5 August 2005. The new rules came into effect after an implementation period of three months on 7 November 2005.

We set out our concerns regarding the proposals relating to disclosure in our letters of 28 February 2005 and 24 June 2005, and we were grateful for the opportunity to discuss these issues with you during a meeting at the offices of the Takeover Panel on 9 March 2005. We expressed our disappointment in our letter of 24 June 2005 that the concerns we raised in our response to PCP 2005/1 – representing the views of the derivatives industry – were not adequately or convincingly addressed. The new disclosure rules are nonetheless in effect and so, of course, now form part of the trading environment for equity derivatives and options.

We note this because the control issues discussed in general terms in PCP 2005/1 are the subject matter of PCP 2005/3, which sets out detailed proposals, building on proposals in PCP 2005/1, with certain variations. A significant difference, of course, is that PCP 2005/3 is accompanied by PCP 2005/4, which proposes the abolition of the SARs.

While we do not have an official position, as the international trade association representing the derivatives industry, on the abolition of the SARs, we welcome any proposal that reduces the regulatory burden on financial market participants. We note that should the Takeover Panel not accept the proposal to abolish the SARs, paragraph 5.5 of PCP 2005/4 indicates that the Code Committee would then publish a further Public Consultation Document setting out a detailed proposal on amendments to the SARs in relation to control issues. We would, of course, study any such proposals should they be issued. We have no further comments on PCP 2005/4.

Turning once again, therefore, to PCP 2005/3, the Code Committee will perhaps not be surprised that we are of the view that the proposals relating to control issues are subject to the same general objection as the proposals relating to disclosure issues, namely, that they are based on the mistaken premise that a derivative position representing a purely economic exposure to the price movement of shares should be equated to a real, direct or controlling interests in shares for the purposes of the Code. We acknowledge that there are some instances in PCP 2005/3 where for a limited purpose a substantive distinction is drawn between ownership or control of shares, on the one hand, and a purely synthetic interest in shares on the other hand.³ But broadly speaking we believe that the central difficulty with the proposals relating to control issues remains the assimilation of synthetic interests to actual interests.

Our responses to the specific questions set out in PCP 2005/3 are:

Question 1. *Do you agree with the proposed amendments in order to implement the broad approach as described in paragraph 4 above?*

² For convenience in this letter we adopt the terminology of the Code, which distinguishes between “derivatives” and “options”, even though an option is, of course, a type of derivative. As we suggested in footnote 2 to our letter of 28 February 2005 a clearer distinction, more in line with market usage, would be between cash-settled derivative transactions (such as contracts for differences (CFDs), swaps and cash-settled options), which are purely synthetic interests, and physically settled derivative transactions (such as physically-settled forward and option transactions), which entitle one party to delivery of a share (in the case of a physically-settled option, if the option is exercised). We note that “option” has been interpreted by the Code Committee itself as including physically-settled forward transactions, for example, in paragraph 6.17 of the PCP on Market-related Issues (PCP 2004/3) issued in June 2004.

³ For example, for purposes of the acceptance condition in Rule 9.3(a).

As indicated in our response to PCP 2005/1, we are not in principle in favour of the extension of the definition of "interests in securities" in the Code, and therefore not in favour of implementation of either the narrow approach or the broad approach. However, as between the "narrow approach" and the "broad approach" to the control issues, as first outlined in PCP 2005/1 and further detailed in PCP 2005/3, we favour the narrow approach. This is closer to our principal position that only positions that give the party long the position actual or effective control of the relevant shares should count for purposes of the control rules. We note, however, that the Code Committee has concluded that the broad approach is preferable and proposed various amendments to the rules on that basis.

The broad approach will result in the 30% barrier potentially triggering application of Rule 9 or Rule 5 without the relevant market participant having anywhere near that level of direct interest or control of the relevant shares. We believe that this would be confusing and unhelpful to the market.

The proposed rules will have the effect of directly regulating the trading of derivatives in circumstances where the parties have no intention of achieving control over a company, and where the person who is long the relevant shares via a cash-settled option or other derivative may have offset its long position with a corresponding short position, so that it is essentially flat relative to the market.

Clearly it is not possible to say that control has passed to an investor in those circumstances simply by virtue of trading in cash-settled derivatives. We do not feel that the case has been made that an investor in cash-settled derivatives even to the extent of 30% of a company's share capital should be obliged to bid for the company and undertake its control. This may, in any event, not be in the company's best interests.

To the extent that the broad approach is retained, we agree with the proposal of LIBA for a modified broad approach, which we understand will be set out in their final response to PCP 2005/3.

Question 2. *Do you agree with the Code Committee's conclusions regarding the acceptance condition under Rules 9.3(a) and 10? In particular do you agree that only shares, and not interests in shares arising by virtue of derivatives and options, should be taken into account under Rule 9.3(a)?*

We agree with the Code Committee's conclusions regarding the acceptance condition under Rules 9.3(a) and 10. Only shares, and not interests in shares arising by virtue of derivatives and options, should be taken into account under Rule 9.3(a). We believe that the reasons supporting this view, set out in the PCP, also support limiting the application of the control rules to shares and to direct controlling interests in shares in the other contexts discussed in the PCP.

Question 3. *Do you agree with the Code Committee's conclusions and proposals regarding the 30% to 50% bands?*

Consistently with our response to question 2, we agree with the Code Committee's conclusions and proposal regarding the 30% to 50% bands.

Question 4. *Do you agree with the proposed amendments in relation to the price at which an offer is required to be made as described in paragraph 6 above?*

If forced to choose between Option 1 and Option 2 to determining the price at which an offer is required to be made for purposes of Rules 6, 9.5 and 11, we prefer Option 2. We note that the Code Committee's preference is Option 1. We believe, however, that a better approach may simply be to use the market price of the relevant share on the trade date of the relevant derivative or option.

Among the difficulties we see with Option 1 are that a deeply out-of-the-money option may be written so that is very unlikely to be exercised. It would not make sense economically for the strike price of such an option plus the relevant option premium to determine the price at which an offer is required to be made. A rational market participant will not acquire the share through exercise of such an option when, by hypothesis, the share is available in the market at a much lower price.

In an extreme case, a party could write a large volume of far-out-of-the-money cash-settled puts with a strike of 1 penny, which would correspondingly therefore have a very low premium. In theory, the party could write enough of these puts to trigger an obligation to bid, while the highest price the party would be deemed to have already "paid" would effectively be zero. While it is not entirely clear what advantage would be gained by a party in doing this, it seems to us to indicate a general weakness of this approach that it should be open to being "gamed" in this way.

Zero strike call options present another instance where the reference price of the option is simply not informative as to the market value of the underlying share. Taking these into account would have the effect of distorting the offer price.

The Code Committee may wish to consider modifying the proposal so that the option strike price is only taken into account for this purpose if the option is actually exercised. In the case of other out-of-the-money options, the Code Committee may wish to consider taking the prevailing market price of the share at the time that the offeror had entered into the option (in other words, applying the Option 2 approach in this context).

In relation to the proposal described in paragraph 6.6 of PCP 2005/3 that a derivative reference price is calculated as the average price of a number of separate acquisitions of interests in securities by the derivative holder's counterparty in order to hedge its position, we would make the following observations:

- (a) The derivative holder will often not have this information from its counterparty, getting only a blended price when the hedge position has been fully established, at which point the formal confirmation of the trade is finalised. The only instance in which a derivative holder will know at what price its counterparty established the physical hedge will be where the derivative holder sold the hedge to the counterparty or where the hedge is established by way of give-up of the trade at the direction of the derivative holder from a third-party to the counterparty. In all other circumstances, the derivative holder will not be aware of the price at which the dealer bought or sold in the cash market.
- (b) The counterparty will hedge its various positions in a share, including its position with a particular derivative holder, on a portfolio basis and on a dynamic basis, that is, adjusting the position to respond to market movements and potentially using a variety of hedges, including, of course, purchase or sale of the share but also proxy hedges, other derivatives such as over-the-counter options, forwards and swaps and exchange-traded futures and options and securities lending and borrowing transactions. Pricing by reference to the counterparty's hedging, therefore, presents significant practical difficulties.

Question 5. *Do you agree with the proposed amendments in relation to the changes in the nature of a person's interest as described in paragraph 7 above?*

We agree with the amendments proposed by the Code Committee in part 7 of PCP 2005/3. In particular, we welcome the clarification that security interests over shares taken by a bank will not normally be considered to be an interest in those shares.

In relation to the second sentence of paragraph 7.5, we assume that a subsequent variation of the option that occurs before the relevant time period would not be taken into account, but only a subsequent variation that occurs after the relevant time period has begun.

Question 6. *Do you agree with the proposed amendments in relation to the single shareholder exception?*

We do not agree with the principal amendment proposed in part 8 of PCP 2005/3, namely, that the exception in Rule 5.2(a) for sales to a single shareholder should not apply to derivatives. If the broad approach is going to be retained, regarding which we have already expressed our general concerns, then we can see no reason in principle why derivatives (that is, cash-settled derivative transactions) should be excluded from eligibility for this exception.

You have noted in paragraph 8.3(b) that the counterparty to such a derivative will normally be a principal trader and therefore, in any event, will not count as a single shareholder for purposes of the exception, as stated in Note 1 to Rule 5.2. Whether or not this is the case, there is no reason, in our view, to exclude derivatives as a general matter from Rule 5.2(a).

Question 7. *Do you agree that it is not appropriate for investment banks and securities houses to be required to make a mandatory bid in the circumstances described above and, if so, do you agree with the introduction of the concept of recognised intermediary status?*

We favour the introduction of “recognised intermediary” status, as we believe that this will bring welcome certainty to the operation of the rules and the various exceptions. We agree that it is not appropriate for investment banks and securities houses to be required to make a mandatory bid in the circumstances described in part 9 of PCP 2005/3.

We note, however, that the Code Committee has suggested in paragraph 9.4 of PCP 2005/3 that shares which the desk owns or controls (that is, those within paragraphs (1) or (2) of the definition of “interests in securities”), and acquisitions or disposals of such interests in shares, will be taken into account in establishing whether a mandatory bid is required, notwithstanding that those shares are owned or controlled by a desk which is a recognised intermediary. These shares, though, will typically be held by that desk to hedge a derivative or option that would be excluded from counting toward the 30% threshold by virtue of the proposed rule. They thus form part of the same customer-driven transaction, and the logic of excluding the derivative extends to the exclusion of the hedge shares.

Question 8. *Do you agree with the criteria by reference to which it is proposed that the grant of recognised intermediary status should be determined? Are there any other matters which should be taken into account?*

We are in broad agreement with the criteria proposed by the Code Committee for the status of recognised intermediary, and we do not have any suggestions as to additional matters to be taken into account.

We note, however, that the Code Committee has only outlined the criteria that the Panel will apply in considering whether a trading desk should be granted recognised intermediary status. Will the Code Committee be publishing more detailed requirements in due course? Clearly, in any event, the Panel will retain significant discretion in deciding whether or not a particular trading desk should be granted recognised intermediary status, and we would urge the Panel to be flexible and pragmatic in making such determinations.

In particular, we are concerned that it is difficult to draw bright lines as to what constitutes client-serving or client-facing activities of a desk, and we believe that the Panel should therefore assess the eligibility of a desk for recognised intermediary status on the basis of the primary activities or primary business of the desk. In other words, we believe that the Panel should not be too narrow in its implementation of the criteria set out in paragraph 10.1 of PCP 2005/3, in particular, sub-paragraph (b).

We would welcome clarification from the Code Committee as to what it considers "proprietary dealing" to encompass. It should be clear that it is not solely putting the firm's capital at risk that determines whether a dealing is a proprietary dealing. Dealers often put their capital at risk when quoting risk bids to clients in relation to derivatives and options.

Question 9. *Do you agree that recognised intermediary status should also be used as the basis for determining whether the exception from disclosure in Rule 8.3(d) should be available?*

We agree that recognised intermediary status should also be used as the basis for determining whether exception from disclosure in Rule 8.3(d) should be available.

Question 10. *Do you agree that the trading desks which may be eligible for recognised intermediary status should not be limited to trading desks which form part of a principal trader (as defined in the Code)?*

We agree that trading desks eligible for recognised intermediary status should not be limited to trading desks forming part of a principal trader (as defined in the Code).

Question 11. *Do you agree with the proposed features of recognised intermediary status referred to above?*

We are in broad agreement with the proposed features of recognised intermediary status as outlined in part 12 of PCP 2005/3, but we would urge the Panel to ensure that the rules for obtaining and maintaining this status be as streamlined as possible, to minimise the additional regulatory burden and cost entailed by the introduction of this status alongside the existing similar status of exempt principal trader.

We note that the Code Committee has suggested in paragraph 12.4 of PCP 2005/3 that, while the Code Committee does not at this stage propose to impose any limits on the size of positions in relevant securities taken by a recognised intermediary desk, it intends to keep the issue under review. We believe that the size of positions taken by a client-serving desk should not be relevant for purposes of the exceptions that will apply to recognised intermediaries. We agree with the Code Committee's proposal not to include any such limit at this stage, and we believe that no such limit should be imposed in the future.

Question 12. *Do you agree with the proposed amendments to the Code referred to above to take account of the introduction of recognised intermediary status?*

The proposed amendments to the Code referred to in part 13 of PCP 2005/3 appear to be consistent with the proposals being made by the Code Committee in relation to the status of recognised intermediary.

Questions 13. *Do you agree with the Code Committee's proposal not to amend Rules 38.1 to 38.4?*

We see no objection to leaving Rules 38.1 to 38.4 unamended.

Question 14. *Do you agree with the proposed amendments to Rule 38.5?*

We have no specific comment on this proposal.

Question 15. *Do you have any comments on Form 38.5(a), Form 38.5(b) or Supplemental Form 38.5(b)?*

We have no specific comments on the forms.

Question 16. *Do you agree with the proposed amendments to Rules 4 and 7.2?*

These changes seem correct to us.

Cost/Benefit Implications. We do not agree that the introduction of these rules will not lead to material new costs for the market. The disclosure rule changes have already added to the cost burden of market participants, and these rule changes will further increase that burden.

Implementation Period. We note that Code Committee has suggested in paragraph 2.2 of PCP 2005/3 that no implementation period will be necessary in relation to the final rules on control issues given that market participants will have adjusted their dealing and reporting systems to take account of the rule changes relating to disclosure, which have been in effect since 7 November 2005. Our members are firmly of the view that the significance of these changes is such that a separate implementation period will be necessary, ideally also of three months.

Finally, we note that the Code Committee acknowledges that the proposed rules relating to control will have significant implications for market participants, and we welcome the Code Committee's stated intention to review the operation of its revised regime for derivatives and options in relation to disclosure and control in June 2007. We would be pleased give our own feedback on the operation of the new rules at that time, or sooner, if requested.

We thank you once again for the opportunity to respond to PCP 2005/3 and PCP 2005/4 and would be happy to discuss our views above with you in more detail if you would find that helpful. If you have any questions or comments regarding this response, please do not hesitate to contact the undersigned (tel. 020 7330 3550, e-mail: rmetcalfe@isda.org).

Yours faithfully,



Richard Metcalfe
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