

# ISDA

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28<sup>th</sup> February, 2005

Dear Sir/Madam,

**Consultation Paper issued by the Code Committee of the Panel on Takeovers and Mergers relating to Amendments proposed to be made to the Takeover Code and the SARs (PCP 2005/1)**

Please find attached below the response of the International Swaps and Derivatives Association, Inc. (ISDA) to the Consultation Paper issued by the Code Committee of the Panel on Takeovers and Mergers on *Dealings in Derivatives and Options* (PCP 2005/1).

As you will see, we suggest in this response, detailed dialogue with derivatives industry specialists in the interests of addressing what we believe are a number of issues arising from the proposals to extend disclosure requirements to cash-settled derivative transactions.

Naturally, if you have any questions on this response, you should not hesitate to contact us, at 7330 3550 / [rmetcalfe@isda.org](mailto:rmetcalfe@isda.org).



Richard Metcalfe  
Senior Director, Policy

**Consultation Paper issued by the Code Committee of the Panel on Takeovers and Mergers relating to Amendments proposed to be made to the Takeover Code and the SARs (PCP 2005/1) – ISDA response****Introduction**

The International Swaps and Derivatives Association, Inc. (ISDA)<sup>1</sup> thanks the Code Committee of the Panel on Takeovers and Mergers for the opportunity to comment on its Consultation Paper on *Dealings in Derivatives and Options* (PCP 2005/1), which raises issues of importance to the market and aims to preserve and improve its transparency and efficiency.

ISDA understands the aims of the Consultation Paper and agrees with the Code Committee that holders of the shares in an offeree or offeror company – and the market generally – should have a clear understanding of:

- where effective control of a company's shares lies; and
- whether persons with significant interests in the shares may be dealing with a view to assisting the offeror or the offeree company such that they are acting in concert.

Promoting transparency in the market is important because the market must be appropriately informed in order to be efficient.

ISDA believes, however, that the specific proposals of the Code Committee will not lead to the desired result of increased transparency, and are in fact likely to have the opposite effect. Much of the analysis in the Consultation Paper appears to be based on what we consider to be a false presumption, namely that every equity derivative<sup>2</sup> creates an interest in favour of the holder of the derivative (the “investor”, in the terminology used in the Consultation Paper) in physical shares. In the vast majority of transactions, that is in fact not the case, as discussed further below.

Our concern is that, if the proposal is mis-specified in the way we outline, then it can only act as a burden on the market, unnecessarily reducing the attractiveness of legitimate risk management instruments which make the market more economically ‘complete’.

PCP 2005/1 is by its terms a preliminary consultation. ISDA believes it is indeed appropriate that the Panel study this issue in greater detail (with, we would urge, specialists from a derivatives-market background) before proceeding with its proposals. Naturally, we would be very happy to help facilitate any such study.

It seems to ISDA that, while there may be some benefit from limited changes in the approach to disclosure of derivatives, the fundamental problem with transparency arises not from the scope of the existing rules but from occasional failures to comply properly with those existing rules, magnified by a perception that such failures are commonplace. Priority should accordingly be given to proper monitoring

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<sup>1</sup> 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, equity and credit.

<sup>2</sup> In the Consultation Paper (and, indeed, in the current version of the Code), the Code distinguishes between “derivatives” and “options”. The Code Committee reserves the former term for cash-settled instruments. We suggest that a clearer distinction – and one that would be more in line with market usage – would be drawn between *cash-settled* derivative transactions (such as 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 (or, in the case of a physically settled put option, to deliver) shares.

of these existing rules, rather than extending them in ways that will bring little benefit and which are more likely to harm legitimate uses of risk management instruments.

Our response is mainly focused on the disclosure requirements. We would, however, note that the concerns that we raise in relation to these requirements would apply equally to the proposals in relation to mandatory bids. Accordingly, we wish to register our opposition to that element of the proposals as well as to the outlined extension of the disclosure regime.

ISDA is aware of the possibility that the Panel will receive a variety of responses from the finance industry, reflecting differing perspectives within firms on this issue. ISDA would simply caution against introducing any change that was based on a presumption as to market practice that had not been adequately proven and the ramifications of which have not yet been fully explored.

### **Detailed proposals**

More specifically, our thinking is as follows.

- Since it is possible to have many derivatives referencing the same underlying shares, the Code Committee's current proposals could result in disclosure of derivatives notional amounts equal in aggregate to a multiple of the outstanding share capital of a company, even after taking into account the 1% long position threshold and the market-maker exemption. This would distort, rather than clarify, the true position as to where control or significant interests in the shares actually lie.
- Therefore, rather than compelling disclosure of all dealings in derivatives for non-market makers that amount to a long position of 1% or more, ISDA and its members submit that it would be more useful, and consistent with the Code Committee's stated aim to promote transparency, to compel the disclosure only of derivatives that by their terms grant the holder of the derivative, or in conjunction with which there is an understanding granting the holder of the derivative, either or both of the following rights:
  - an ability, directly or indirectly, to influence how the shares are voted now or in the future;
  - an ability, directly or indirectly, to acquire a physical long position in the shares, now or in the future, either pursuant to the derivative, contemporaneously or following termination of the derivative.

The advantage of this is that it would capture what one would characterise as 'real' interest in the shares, as distinct from a purely economic interest in the *price* of the shares. To be absolutely clear, ISDA does not maintain that it is only 'price players' who will ever be active in entering into derivatives during bids. Equally, however, there is a well-established and reported market of activity in relation purely to price, which is particularly marked in relation to the stocks of companies involved in takeover bids. For example, merger arbitrage, which is an investment strategy that takes advantage of the price fluctuations of shares during a takeover bid, is a well-known investment strategy. It is, in our view, a normal and harmless consequence of a market economy that this should be the case. Equally, it is damaging to effectively penalise the use of derivatives as an efficient means to gain exposure to such price fluctuations, and does not achieve the desired results.

It is notable that (as PCP 2005/1 itself makes clear) Note 11 Rule 9.1 of the Code reflects the possibility that the Panel will exercise its judgement in relation to the use of options, specifically as to whether “the relationship and arrangements between the two parties are such that effective control over those shares has passed to the taker of the option”. Our suggested approach appears to be in the same vein as this, in that a significant degree of discretion would reside with the Panel (in relation to all types of derivatives, and not merely options) as to whether or not an understanding exists between the “investor” (customer) and the “counterparty” (dealer).

In connection with this point, we should also like to note a highly questionable assertion in paragraph 3.1 of the PCP. Here it is stated (with emphasis added by ourselves): “As a matter of law, title to the hedge shares (in the case of a long CFD) is held by the counterparty and the *contractual arrangements* between the holder of the CFD and the counterparty usually reflect this.”

Not only is ISDA not aware of any such *contractual* arrangements being deployed; on the contrary, market feedback suggests that, if anything, “counterparties” (ie, dealers) will, for the avoidance of doubt, document with their customers the fact that those customers should *not* expect to claim any interest in shares that may (but, depending on the dealer’s position and policy, will not necessarily) be held as a hedge of derivatives positions.

By way of support of this point, we respectfully draw the Code Committee’s attention to the market-standard documentation that has been in use since 2002, in the UK as well as several other jurisdictions around the world. The ‘2002 ISDA Equity Derivatives Definitions’ is the widely accepted basis for documenting a wide range of transactions. Specifically (in section 13.2, reproduced by way of Annex to this response), this publication provides template language to the effect that customers categorically may *not* expect to claim any interest in shares that may (but will not necessarily) be held as a hedge of derivatives positions.

### **Drafting suggestions**

Although the Code Committee is best placed ultimately to decide how it might amend the Code and the SARs in order to achieve the disclosure of derivatives that grant the rights set out above (or in conjunction with which there is an understanding granting such rights), the following is a relatively straightforward example of how Rule 8.3(d) could be amended to achieve the Code Committee's aims:

- As suggested in the Consultation Paper, Note 7 to Rule 8.3 would be deleted.
- In addition, the definition of “relevant securities” in Note 2(e) to Rule 8.3 would be amended as follows:
  - “(e) *options in respect of any of the foregoing and derivatives referenced to any of the foregoing, provided that the holder of such option or the long position under such derivative has, pursuant to or concurrently with entry into such option or derivative, acquired either or both of the following rights:*
    - (a) *an ability, directly or indirectly, to influence how the shares are voted now or in the future;*

- (b) *an ability, directly or indirectly, to acquire a physical long position in the shares, now or in the future, either pursuant to the derivative, contemporaneously or following termination of the derivative.”*

### **Other considerations**

ISDA understands that the Code Committee is concerned that, although the contractual arrangements between the parties to a derivative may not document the rights discussed above, the holder of a derivative may still be able to exercise a degree of *de facto* control over the shares that are held as a hedge by the counterparty, due to the nature of the relationship between the holder and the counterparty, which (as the Code Committee characterises it) is often a dealer that will seek to retain the business of its client.

This characterisation of dealers’ interests is somewhat simplistic, in our view. While a given investor might wish that certain shares could be voted in a particular way, dealer firms will have a range of customers across a range of services and will have a natural interest to avoid taking sides among such customers. The firm will, in fact, derive significant benefit from obviating such conflicts of interest. Furthermore, apart from having a general interest in the integrity (and perceived integrity) of the market, dealers are unlikely to wish lightly to jeopardise their market-maker status or indeed the tax treatment of such transactions. In any case, there are provisions of the Companies Act of which firms would prudently wish to be mindful.

Such evidence as there is does not suggest that instances of questionable activity are common and certainly does not suggest they are a norm. We note that only two specific (and, in our view, inconclusive) examples are given in paragraph 3.4 of the Consultation Paper. ISDA's own detailed consultation with member firms in relation to the Consultation Paper indicates, in contrast, that the leading dealers have a strict policy *against* voting hedge shares in accordance with the instructions of a counterparty to a derivative transaction. Moreover, many firms have a further policy whereby, even if they reserve the (theoretical) right to vote those shares in accordance with their *own* best interests (and without regard to the wishes of any of their derivative counterparties), such voting would be subject to stringent compliance checks.

The Code Committee adduces two cases intended to illustrate market practice. ISDA has concerns about these examples. As regards the comments in PCP 2005/1 paragraph 3.4 (a), the “market practice” referred to in fact reflects an expectation that apparently exists on the part of some investors as to what practice would be – that is, strictly speaking, not the same as market practice itself. Similarly, addressing the point in the example in 3.4 (b), notwithstanding that the investors act as if they are shareholders, the derivatives transactions they enter into do not make them so.

These essentially circumstantial points do not strike ISDA as firm grounds for policy-making. Expectations may be voiced but it does not follow that they will be acted on. ISDA has no hesitation in recommending robust measures to compel compliance where a tactic is deployed to avoid a reasonable disclosure requirement. On the other hand, in the interests of building a true picture of activity as much as avoiding unnecessary burden, the requirement should be framed to catch only those instances that are relevant.

In any event, we firmly believe that the concern of the Code Committee can largely be allayed by putting in place the measures referred to above.

- As proposed in the Consultation Paper, the person responsible for disclosing dealings should properly be the investor. Accordingly, the exemption from disclosure for market-makers under Rule 8.3(d) should continue to apply unchanged. On this latter point, we do, however, note the following: Given that derivatives dealers will often, if not always, enter into their hedges via their cash trading desks, the scoping-in to the disclosure rules (by limiting the applicability of the Rule 8.3(d) exemption) of “proprietary trading desks” of parties that are otherwise exempt will, in practice, need to be handled with particular care. In other words, hedging effected by or for the account of the customer desk should not be subject to the same rules as proprietary trading proper.
- If the terms of the derivative give the right, or there is an understanding between the parties to the derivative that the holder will have a right, to
  - (i) influence directly or indirectly how the shares are voted in the future; and/or
  - (ii) acquire directly or indirectly a physical long position in the shares that are held by the dealer as a hedge, now or in the future, either pursuant to the derivative, contemporaneously or following termination of the derivative;

the holder of the derivative will have the obligation to disclose details of any trading in the derivative (subject to the 1% threshold as discussed above). The market would then be on notice as to where true control lies of the shares comprising the notional of that derivative.

### **Technical considerations**

ISDA recognises that, as a general principle, market transparency is desirable at the time a bid is proceeding. Notwithstanding that the logic we have set out in relation to disclosures more generally would continue to apply, and taking our cue from paragraph 4.5 of PCP 2005/1, ISDA understands that the Panel might wish to have an extra safeguard in place where the derivatives positions were uncommonly large. ISDA would be pleased to discuss with the Panel any specific policy avenues that may be relevant in relation to this point.

Also on a more technical note, if the Takeover Code is amended to require the disclosure, at least in some cases, of derivatives over a certain threshold, a methodology will need to be established in order to calculate whether a holding of derivatives meets the thresholds for holdings of relevant securities. In the case of derivatives such as CFDs and equity swaps, the methodology is simple as there is a one-to-one relationship between the size of the derivative position and the number of the underlying shares held as a hedge. The “delta” is always one, hence these are sometimes referred to in the market as “delta-one products”.

However, in the case of options, the correlation between the size of the option position and the number of underlying shares held as a hedge will change over the life of the option, depending on the movements in the price of the shares in relation to the exercise price documented in the option. It is important to note, however, that the exercise price of an option is not relevant or descriptive of the market price of the underlying shares at any time, as is illustrated by the wide range of strike prices quoted across puts and calls associated with any given share at any given time. For example, the value of an option that is very far out-of-the-money will have a very low correlation to the market price of the underlying shares.

As regards options, we note that PCP 2005/1 proposes (in paragraph 7.5) that both bought calls and written puts should count towards long interest, for the purposes of disclosure thresholds. Depending on

the strike prices involved, however, it might well be illogical for both to count towards a long interest simultaneously. For instance, if both strike prices are out of the money at a given point in time, only one can economically be worth exercising at expiry.

In any case, a (physically settled) written put would, of course, only offer discretion (as to share transfer) to the existing holder of shares, not to the option writer. And a bought call would not necessarily offer an 'exit strategy' to the existing shareholder (as appears to be suggested in paragraph 14.7 (b) (iii) / page 34 of PCP 2005/1), unless the option holder was prepared to exercise when it was economically disadvantageous to do so.

Finally, the Code Committee should note that the timeline suggested in the Consultation Paper for disclosure of any derivatives would be very difficult, if not impossible, to comply with in practice, particularly on a group-wide basis. The standard practice in derivatives markets is for short-form trade confirmations to be sent by the dealer to the client within three (3) days of the trade date, with a complete confirmation setting out all details of the derivative transaction to follow in due course. Even in a nominally 'T+0' environment (which the derivatives industry is working towards), there could be significant uncertainty as to definitive positions, as well as substantial costs for technology and compliance build-out.

**Annex**

Extract from '2002 ISDA Equity Derivatives Definitions' (emphasis in text added)  
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**Section 13.2. Agreements and Acknowledgments Regarding Hedging Activities.**

(a) If "Agreements and Acknowledgments Regarding Hedging Activities" is specified as applicable in the related Confirmation, then unless agreed to the contrary expressly and in writing in the related Confirmation for a Transaction and notwithstanding any communication that each party (and/or its Affiliates) may have had with the other party, each party to a Transaction agrees and acknowledges that (i) when entering into, or continuing to maintain, such Transaction, neither party is relying on (A) the manner or method in which the other party or any of its Affiliates may establish, maintain, adjust or unwind its Hedge Positions, (B) any communication, whether written or oral, between the parties or any of their respective Affiliates with respect to any Hedging Activities of the other party or any of its Affiliates, or (C) any representation, warranty or statement being made by such party or any of its Affiliates as to whether, when, how or in what manner or method such party or any of its Affiliates may engage in any Hedging Activities and that (ii) (A) each party and its Affiliates may, but are not obliged to, hedge any Transaction on a dynamic, static or portfolio basis, by holding a corresponding position in the securities or indices referenced by or underlying such Transaction or in any other securities or indices or by entering into any Hedge Position; (B) any Hedge Position established by either party or any of its Affiliates is a proprietary trading position and activity of such party or such Affiliate; **(C) each party or such Affiliate is not holding the Hedge Positions or engaging in the Hedging Activities on behalf or for the account of or as agent or fiduciary for the other party, and the other party will not have any direct economic or other interest in, or beneficial ownership of, the Hedge Positions or Hedging Activities;** and (D) the decision to engage in Hedging Activities is in the sole discretion of each party, and each party and its Affiliates may commence or, once commenced, suspend or cease the Hedging Activities at any time as it may solely determine.