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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

E-mail: supportgroup@thetakeoverpanel.org.uk

Dear Sir/Madam

Public Consultation Paper issued by the Code Committee of the Panel on Dealings in Derivatives and Options (PCP 2005/2)

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 the Public Consultation Paper (PCP) issued by the Code Committee on 13 May 2005 on *Dealings in Derivatives and Options* (PCP 2005/2). The PCP contains detailed proposals relating to amendments proposed to be made to the Takeover Code in relation to disclosure issues. It follows the PCP issued on 7 January 2005 (PCP 2005/1), which dealt with disclosure and control issues in relation to dealings in derivatives and options, and to which we responded in our letter to you of 28 February 2005.

We note that in PCP 2005/2 the Code Committee deals only with disclosure issues, deferring discussion of control issues to a future PCP. We also note that the Code Committee intends to publish a Response Statement on the disclosure issues following the current phase of consultation, in which you will address in detail the responses you received to the questions on disclosure in PCP 2005/1.

1. The Code Committee proposals in PCP 2005/1 and ISDA's response

We set out in some detail in our letter of 28 February 2005 our concerns regarding the disclosure and control proposals outlined by the Code Committee in PCP 2005/1, and we thank you once again for having provided us with the opportunity to discuss our concerns with you at a meeting at the Panel's offices on 9 March 2005.

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, equity and credit.

- By way of brief reminder, in our response of 28 February 2005 we acknowledged and supported the stated aims of the Code Committee's proposals regarding transparency.

We expressed our concern, however, that the specific proposals of the Code Committee will not lead to the desired result of increased transparency, but are, in fact, likely to have the opposite effect. We also expressed our concern that the proposals are unduly burdensome, unnecessarily reducing the attractiveness of legitimate risk management activity which, if unimpeded, would help to ensure a more efficient allocation of economic risk in the equities market. We suggested that the problem the Code Committee is seeking to address arises, in our view, not from the scope of the current rules but from occasional failures to comply properly with those rules, magnified by a perception, which we do not share, that such failures are commonplace. We urged that the rules should focus on capturing real, direct or controlling interests in shares as opposed to a purely economic interest in the *price* of the shares.

During our meeting with you on 9 March 2005, you raised "price discovery" as a consideration in the proposed rule changes, although you admitted that it is not "majored on" in PCP 2005/1. We note that this issue is given more prominence in the current PCP, and we comment on it below.

2. The Code Committee's current proposals relating to disclosure

We note the general conclusion of the Code Committee following its consultation that there is no reason to alter its overall approach in relation to disclosure issues and the principal measures that were proposed.² Not surprisingly, we find this disappointing, since we do not believe that the concerns raised in our response to PCP 2005/1 – representing the views of derivatives specialists – have been adequately or convincingly addressed. Nonetheless, our comments here focus on amendments to the proposals, new issues or new "angles" on the original issues.

Given our continuing concerns regarding the Code Committee's proposals, we welcome the Code Committee's proposal to review the operation of the new rules after 18 months. (We would, naturally, be happy to assist in that review.)

We acknowledge that some marginal improvements have been made to the proposals in PCP 2005/1, relating to points we raised in our response, including:

- introduction of a three-month implementation period (para. 3.2)
- amendment of the definition of "derivative" to reflect market usage (paras. 6.18 and 6.19) (although there are some points in PCP 2005/2 where the term "derivative" is used as though it refers only to cash-settled transactions)
- extension of the disclosure deadline in Rule 8.3 from midday on the business day following the relevant dealing to 3.30 p.m. (para. 10.5) (although we believe that this is still too tight a deadline in practice, particularly on the first day of dealings after a bid announcement, and will prove onerous for market participants)

We would also like to raise the following points, which are supplemental to those raised in our prior response:

² PCP 2005/2, para. 1.4.

- (1) Regarding the “price discovery” objective of the proposals, in paragraph 5.2 of PCP 2005/2, you state that a “derivative investor or option holder with a purely economic, rather than strategic, motivation is still likely to want to influence the way in which the holder of underlying shares acts in respect of an offer for the company”. That may or may not be the case, but represents merely the internal state of mind of the derivative investor. The key question is whether that person is actually able to influence a holder of the shares. For the reasons given in our prior response, we believe that the current Code rules, properly monitored and enforced, will adequately deal with these situations.

Finally, in this regard, we believe that current rules relating to market manipulation and market abuse provide adequate protection from other types of behaviour in which a synthetic investor in a share subject to offer might engage in order to influence the price of the share.

- (2) In relation to the Panel’s review of the principal trading activities of all relevant investment banks, referred to in paragraph 12 of PCP 2005/2, we believe that, in undertaking this review, the Panel should bear in mind that derivatives dealers will often, if not always, enter into their hedges via their cash trading desks. Thus special care should be taken when narrowing the scope of the Rule 8.3(d) exemption for market-makers to exclude “proprietary trading desks”, so as to ensure that hedging for the account of the customer desk remains within the market-maker exemption.

On the same topic, there appears to be an implication in the text cited in paragraph 12.2 of the PCP that proprietary trading would be carried out by a distinct legal entity within a group. While this might be true in some instances, we would submit that it would be wrong to assume it generally to be the case.

- (3) On a more technical note, we observe that paragraphs 6.35 to 6.38 of PCP 2005/2 deal with securities borrowing and lending. A securities borrowing/lending transaction is not considered a dealing for purposes of the current rules, and the Code Committee proposes that this practice should continue. We agree that this is appropriate.

It would be useful to clarify that the same rule would also apply in relation to an equities repurchase (repo) transaction. Such a transaction would have a similar economic effect and, as in the case of securities borrowing/lending, is based on the transfer of title to the securities to the repo purchaser (who is analogous to the securities borrower), subject to a contractual right to return equivalent securities.

Paragraphs 6.43 to 6.44 deal with security interests over shares and proposes that the taking of security over the shares should not be considered the acquisition of an interest in the shares for purposes of the proposed rules. We endorse this approach.

Furthermore, in this regard, we believe that the transfer of title to shares under a title transfer collateral arrangement other than a securities borrowing/lending transaction or equities repo transaction should also not be considered the acquisition of an interest in the shares for purposes of the proposed rules. Title transfer collateral, for example under the ISDA Credit Support Annex (Bilateral Form – Transfer), is the most common type of financial collateral arrangement used in the European derivatives markets and is

recognised, for example, in the European Financial Collateral Arrangements Directive³ and in the UK implementation of that Directive.⁴

Securities borrowing/lending and repo transactions represent a specialised form of this type of arrangement, but when used, for example, in connection with an ISDA Master Agreement, a title transfer collateral arrangement involves the transfer of securities to the collateral taker without a corresponding payment by the collateral taker of an amount equal (more or less) to the market value of those securities at the time of transfer, as would normally occur under a securities borrowing/lending or repo transaction. Therefore we believe that an express mention of title transfer collateral arrangements is necessary to ensure consistent application of the proposed rules.

Finally with regards to securities borrowing/lending, we believe that there is a need to clarify the treatment of on-lending of securities. On one reading of the current proposals, securities that have been borrowed (and as such are not disclosable) could become disclosable (as loaned securities) upon any on-lending. Given that such on-lending or 'rehypothecation' is common practice in the management of collateral used to secure derivatives-related exposures, we believe it would be helpful to clarify the policy which we expect would apply, namely that it is the initial borrowing (and not any subsequent on-lending) that determines the status of such securities in relation to the disclosure rules.

- (4) The Code Committee's proposed revised definition of "interests in securities" is broad enough to cover a trade on an index that includes a relevant security as a component of the index. In practice, however, the extension of the rules to cover index trades would be unworkable, extremely difficult to monitor or comply with, and therefore unduly burdensome.

Since an index trade is a purely synthetic or "price" play in relation to the shares this problem would not arise if the rules are reformulated in the manner we suggested in our response to the first round of consultation on this matter.

On a related point, while we fully understand the motivation behind the proposed new Note 7 to Rule 8 (dealt with in paragraph 9.4 of the PCP, addressing possible 'bed-and-breakfast' arrangements), we respectfully suggest that the wording is so broad as to capture even casual conversations about the relevant securities.

Moreover, because the proposed new Rule 8.3(b) works by reference to such an "interest in relevant securities", it would we believe capture derivatives when this, in our understanding, is not the intention of the rule.

- (5) In relation to the acquisition of an "interest in securities", we believe it would be helpful if the Code Committee could clarify its proposal in paragraph 6.15 of the PCP 2005/2 as regards its application to ordinary forward contracts relating to a share. What would an "abnormally long settlement period" mean in relation to a forward? Is the time of execution of a forward transaction the appropriate time to consider the interest, in effect, transferred from forward buyer to forward seller? We think that the appropriate time in

³ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

⁴ The Financial Collateral Arrangements (No. 2) Regulations 2003.

this case should be the time of settlement, which would be more consistent with market expectations and with the legal effect of the transaction.

- (6) We note that, under the proposal in paragraph 6.40, warrants (which must in the context mean physically settled warrants) in respect of new securities will not give rise until exercise to an interest in the securities which may be issued. Some warrants, however, may leave it open as to whether exercise can be satisfied by delivery of new or existing shares. We would be interested to know how the Code Committee would propose to deal with such an instrument .
- (7) It does not appear that our technical considerations regarding the application of the proposed rules in relation to options have been taken fully into account in PCP 2005/2.

We thank you once again for the opportunity to respond to PCP 2005/2 and would be happy to have a more detailed dialogue with you regarding the perspective of derivatives specialists and the OTC derivatives market on the Code Committee's proposals. If you have any questions or comments regarding this letter, please do not hesitate to contact us at 7330 3550 / rmetcalfe@isda.org.

Yours faithfully,



Richard Metcalfe
Senior Director, Policy