

ISDA

International Swaps and Derivatives Association, Inc.
24 Raffles Place
#22-00 Clifford Centre
Singapore 048621
Telephone: (65) 6538-3879
Facsimile: (65) 6538-6942
email: isdaap@isda.org
website: www.isda.org

c/o Allen & Overy
9th Floor, Three Exchange Square
Central
Hong Kong
Telephone: (852) 2974 7000
Facsimile: (852) 2974 6999

Securities and Futures Commission
8th Floor, Chater House
8 Connaught Place
Central
Hong Kong

Our ref 30047-00630 HK:1054655.4

28th February 2005

Attention: Secretary to the Securities and Futures Commission

Dear Sir/Madam,

Review of the Disclosure of Interest Regime under Part XV of the SFO

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 the SFC's Consultation Paper on the Review of the Disclosure of Interest Regime under Part XV of the Securities and Futures Ordinance (the "**SFO**") published in January 2005 (the "**Consultation Paper**").

ISDA is an international organisation whose membership comprises over 600 of the world's largest commercial, merchant and investment banks, corporations, government 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 current list of ISDA's members is available on its website at www.isda.org.

1. Introduction

First and foremost, ISDA welcomes the objectives of the Consultation Paper and is grateful for the opportunity to comment on the SFC's proposals in relation to Part XV of the SFO ("**Part XV**"). ISDA agrees with the importance of balancing the need to remove unnecessary and unduly burdensome requirements while preserving transparency in the market and keeping Part XV of the SFO in line with developments of the Hong Kong securities market. While ISDA is supportive of many of the proposals raised in the Consultation Paper, ISDA members have the following specific concerns and comments in relation to the Consultation Paper.

- Section 1.1 Forms and Codes – ISDA questions the aggregation of derivative interests with proprietary interests in shares and disagrees with the insertion of "D" in a notice as a result of a transaction involving derivatives; ISDA does not support the addition of new codes in relation to derivative transactions as it is unnecessary and may serve to further confuse market participants.
- Section 2.5 Credit Derivatives – ISDA is of the view that both cash and physically settled credit derivatives with convertible bonds or exchangeable bonds as their underlying reference asset are not to be subject to disclosure as they fall outside the relevant definitions for disclosure. A clarification or statement to this effect will be welcomed.
- Section 3.5 Exempt Security Interest – ISDA agrees with the SFC's policy intent that the exemption should be applicable for derivative transactions where collateral is taken by way of title transfer.
- Section 4.3 Complex and other derivatives – in principle ISDA supports the SFC's views that disclosure treatment for derivatives should not be dependent on documentation style and that it is permissible to report a person's "effective" long and short positions. While ISDA acknowledges that as a general rule, netting should not be permissible, however, under certain scenarios, netting should be the logical method of disclosure when a person discloses his "effective" position.

2. Section 1.1 - Forms and Codes

While ISDA appreciates the SFC's objective behind the introduction of new codes, ISDA members are of the view that the introduction of more codes in relation to derivative transactions is unnecessary and may serve to further confuse the market participants. This is so for the following reasons.

- (a) Under the existing forms, disclosure of derivative interests are already provided for in Box 21. The existing codes for Box 21 as set out in Table 4 are already sufficient to identify the category and the nature of derivative interests comprising the total interest of substantial shareholders. The introduction of more codes would add to the burden for market participants to break down their total interests held by way of derivatives into different codes, and such a break down will not present any meaningful disclosure.
- (b) The addition of further codes in Box 17 to denote derivative transactions will further complicate disclosures in this area. We note in paragraph 2.6.4 of the SFC's Outline of Part XV that the SFC recognizes the only practical way to report is on an end of day basis, and therefore submit one form per day. Due to the configuration of Box 17, substantial shareholders are required to select one code which best describes the transactions occurring on that day. This already leads to misleading disclosures where the relevant transactions are a combination of transactions represented by different codes, and substantial shareholders are required to choose one code which best represents the day's reportable activities. Accordingly, by adding more categories of codes, and requiring the addition of "D" to denote derivative transactions, this problem is only exacerbated, and not alleviated.
- (c) ISDA members have noted the relatively few disclosures made in relation to Box 21. Given the perceived high level of disclosure currently existing in the market, ISDA members query whether the lack of disclosure in this area is due to the difficulties faced by substantial shareholders in further breaking down multiple positions into the codes offered in Table 4. ISDA therefore believes that the introduction of new codes in Table 4 would not enhance disclosure by market

participants and ISDA seriously questions the usefulness of any information provided by way of the new codes and the ability of users of this information to readily understand the nature of the transactions giving rise to the notifications.

In addition, ISDA notes that the SFC has proposed to introduce the insertion of the letter "D" to the front of the code in relation to transaction involving derivatives. ISDA believes that such insertion would unnecessarily single out derivatives and may have an overall negative connotation.

In light of the above concerns, ISDA suggests that instead of the introduction of new codes and explanatory notes, the SFC should give more clarifications as to the use of the existing codes so as to increase the level and accuracy of the disclosure made in relation to the existing boxes.

ISDA notes that the above issues may have stemmed from the conceptual problems with the aggregation of derivative interests and proprietary interests in shares for disclosure purposes. Such disclosure may potentially create misleading impressions and even misinformation as proprietary interests and derivative interests are fundamentally and qualitatively different. For example, the holder having a direct interest will have a proprietary interest and voting rights in the shares of the listed company (and hence control in respect of the company) while the holder of mere economic interests will not. Accordingly, it may not be meaningful for direct and derivative interests to be aggregated and may result in disclosure that is neither required nor needed to achieve transparency.

3. Section 2.5 Credit Derivatives

ISDA is of the view that credit derivatives with convertible bonds or exchangeable bonds as underlying reference assets should not be subject to disclosure. ISDA believes that such derivatives do not fall within the relevant definitions to warrant disclosure. To illustrate this, an investor (X) has entered into a credit default option ("**Credit Default Option**") with a counterparty (Y). The terms of a Credit Default Option would typically contain the following provisions:

- on occurrence of certain credit default events relating to an issuer (the "**Reference Entity**"), X may put certain exchangeable bonds (EBs) issued by the Reference Entity to Y. In this case, the EBs will be the reference asset.
- on exercise of the put option, Y is required to pay an amount to X for the EBs at a pre-determined strike price set out in the Credit Default Option.
- credit default events under a Credit Default Option would include the winding up of the Reference Entity, default under the EBs by the Reference Entity, or other primarily insolvency-related events of the Reference Entity, all of which, we understand, would almost certainly render the equity element of the EBs valueless.

ISDA's understanding is that "an option (a Credit Default Option) to put an option over underlying shares to another person" would appear to fall within the definition of an "equity derivative" under the SFO. However, ISDA's view is that an EB does not fall within the definition of "underlying shares" nor will X's position fall within definition of "short position" and accordingly does not trigger any disclosure.

3.1 What are "underlying shares"?

Under the SFO, "underlying shares" for a substantial shareholder is defined as:

- "(i) the shares comprised in the relevant share capital of the listed corporation concerned which may be required to be delivered to, or by, the holder, writer or issuer of the equity derivatives on the exercise of rights or fulfilment of obligations under the equity derivatives, whether in any case the rights or obligations are conditional or absolute; or*
- (ii) the shares comprised in the relevant share capital of the listed corporation concerned by reference to the price or value of which, wholly or partly, the price or value of the equity derivatives is derived or determined..."*

In ISDA's view, EBs would not fall within either of these definitions for "underlying shares".

3.2 Is there a "short position"?

A "short position" is defined as:

- "(a) where the person is the holder, writer or issuer of any equity derivatives, by virtue of which the person:*
 - (i) has a right to require another person to take delivery of the underlying shares (our emphasis) of the equity derivatives;*
 - (ii) is under an obligation to deliver the underlying shares (our emphasis) of the equity derivatives to another person, if called upon to do so;*
 - (iii) has a right to receive from another person an amount if the price of the underlying shares (our emphasis) of the equity derivatives declines; or*
 - (iv) has a right to avoid or reduce a loss if the price of the underlying shares (our emphasis) of the equity derivatives declines,*
- before or on a certain date or within a certain period, whether in any case the right or obligation is conditional or absolute...."*

On exercise of a physically settled Credit Default Option, X would have the right to require Y to take delivery of the EBs on occurrence of a credit default event of the Reference Entity. X would **not** have any right to require Y to take delivery of the underlying shares of the equity derivatives (i.e. shares of Listco). Furthermore X would not benefit from any fluctuation of the share price of ListCo. In ISDA's view, a physically settled Credit Default Option would not fall under (i) or (ii) of the definition for "short position".

In respect of a cash settled Credit Default Option, upon the occurrence of a credit default event of the Reference Entity, the price of the EBs will decline and X has a right to receive from Y an amount which represents the difference between the market price and the strike price of the EBs. However, the right to receive such an amount is **not** triggered by virtue of the decline of the price of the shares of Listco. A decline in price alone will not trigger any right of payment on X – there must be a credit default event of the Reference Entity (which would inevitably trigger a decline in the price of the EB). Accordingly, in our view, a Credit Default Option would not fall under (iii) and (iv) of the definition for "short position" either.

Based on the analysis above, ISDA's understanding of the SFO is that a Credit Default Option (cash or physically settled) in the circumstances described above does not appear to be a "short position" under Part XV which requires disclosure by X, the buyer of the Credit Default Option. As a result of all the above, ISDA considers that it is unnecessary to provide any draft wording for an exemption, as proposed by the SFC.

Similar issues would also apply to Y, the seller of the Credit Default Option, as it appears that Y may be required to disclose its long position in ListCo by virtue of the Credit Default Option.

The SFC will agree that the conclusion above is consistent with the legislative and policy intent of Part XV in that disclosure under Part XV is concerned with the level of interests in shares/equities. It remains ISDA's view that credit derivatives such as the Credit Default Options are a "play on credit" rather than on equity. When a credit derivative transaction is entered into in respect of a convertible bond or an exchangeable bond, the contracting parties are transacting in respect of the "credit" portion of the bond only whilst the equity portion of the bond is purely incidental to the transaction. Accordingly, we understand that credit derivatives are priced and traded on the basis of the credit spread of the bond without regard to the equity conversion/exchange value of the convertible bond or exchangeable bonds. In addition, it should also be noted that upon the occurrence of a credit event, it is invariably the case that the equity portion of the convertible bond will carry little (if any) value after the credit event.

In light of the above analysis, ISDA seeks SFC's confirmation that credit derivatives with convertible bonds or exchangeable bonds as their underlying reference asset should not be subject to disclosure. If the SFC would like to discuss this issue further or would like support in drafting an appropriate confirmation or carve out in relation to credit derivatives linked to convertible or exchangeable bonds, ISDA would be more than happy to assist so as to reach a mutually beneficial and acceptable position.

4. Section 3.5 Exempt Security Interest

ISDA agrees with SFC's proposal that the exempt security interest shall apply to collateral arrangements where there is an absolute transfer of title.

Whether security/collateral is given by way of title transfer or grant of security interests shall not affect the validity of the exemption. This is because both forms accord to the same function - that is, the provision of security/collateral and hence the form in which the security is taken should not have any impact on whether or not there is an exemption.

ISDA further notes that, the legislative intent of the Stamp Duty Ordinance seems to share a collaborative view with respect to title transfer collateral arrangement. Under section 27(5) of the Stamp Duty Ordinance, a transfer made for nominal consideration for the purpose of securing the repayment of an advance or loan shall be exempt from stamp duty. In this connection, the Inland Revenue Department has also issued an interpretation & practice note in January 2000 No.2 (Part A) entitled "Relief For Stock Borrowing and Lending Transactions" confirming that collateral which takes the form of title transfer will have the benefit of stamp duty concession under section 27(5) of the Stamp Duty Ordinance.

It is common in the market that the 1995 Credit Support Annex (English law) being a title transfer collateral arrangement is also registered at the Stamp Office as a stock borrowing and lending agreement for stamp duty purposes.

In light of the above discussion, ISDA would therefore be grateful if the SFC could confirm that, the fact that the CSA also has a stock lending and borrowing feature should not have any bearing on the availability of the exemption as the underlying function of the CSA is the same as other arrangements which grant security interests, that is, the provision of security or collateral.

5. Section 4.3 Complex and other Derivatives

Although ISDA is pleased that the SFC is of the view that disclosure treatment for derivatives should not depend on documentation, ISDA would like to point out that disclosure under the current regime would be different depending on the documentation style commonly used in the derivatives market. In the Consultation Paper, the SFC permits a person to report the effective short and long positions. Yet, the SFC expressly disallows the long and short positions to be netted off. While ISDA strongly agrees that a person should be allowed to disclose its effective position and acknowledges that as a general rule, short and long positions should not be netted off, ISDA is of the view that in the instances outlined below, in order to calculate one's "effective position", netting off is inevitable and is the most logical way of disclosure.

For example, a "call put combo" which contains both put and call elements over the same specified number of shares where only one side of the contract can ever be executed may result in different treatment depending on the form of the documentation used. If a single document is used then it may (depending on particular terms and appropriate use of formulae) be possible to avoid having any discloseable interest by drafting the contract appropriately. However, if the more traditional approach of using separate documents for each side of a trade involving both put and call elements is used then multiple disclosure obligations are likely to arise. As only one side of a trade can be executed, disclosing interests of more than the specified number of shares would be misleading and would make no commercial sense. Accordingly, ISDA advocates that for different option strategies over the same specified number of shares, SFC should expressly allow for netting off. It is by doing so that the effective position of the parties can be calculated.

ISDA believes it would be constructive to consider the extent to which some netting of positions in paired trades could be allowed for the purposes of determining discloseable interests. This is so as it is not uncommon in the market that, in order to "reverse" a trade (e.g. X sells a put option from Y), participants enter into "squaring transactions" (e.g. Y sells X a put option on completely identical terms having the same economic effect). This is a more common approach in the market as compared to the termination of the trade via the execution of a confirmation. However, due to the difference in documentation style, the current treatment between the two approaches is different. To achieve an accurate disclosure of a person's effective position, ISDA strongly supports that for transactions with identical terms and economic effect that are capable of being legally cancelled out of one another, netting off of a person's short and long positions be allowed in this particular instance.

In light of the above, ISDA would welcome a statement from the SFC that, whilst in the general circumstances, netting off of short and long positions is not allowed, in the two instances described above, SFC would allow the netting off to achieve disclosure of a person's "effective" long and short positions.

6. Miscellaneous

ISDA fully supports the object of the Consultation Paper and is grateful for the opportunity to express its comment. ISDA strongly believes that this exercise presents a valuable opportunity for market participants to comment on the current issues and proposed changes so as to achieve greater transparency in the market and to improve Part XV in line with developments in the Hong Kong securities (in particular derivatives) market.

ISDA is particularly pleased that the SFC is expressing its views and proposals in response to the comments from market participants so far. However, as a general comment, ISDA has been advised that the SFC has recently been declining to answer queries relating to the interpretation of Part XV of the SFO and accordingly ISDA is concerned about the possible implications of this. Given the complexity of these provisions and the uncertainty surrounding the application in certain cases, from both a legal and a market perspective, it is inevitable that persons affected or potentially affected by Part XV and their advisers will need to seek guidance from the market regulator from time to time. Where the market regulator is unable or unwilling to provide clear guidance, market participants will need to proceed on the basis of their own and/or their professional advisers, interpretation of the relevant provisions and certain adverse consequences may follow. Different market participants and/or their professional advisers may reach different interpretations on relevant issues - resulting in inconsistencies in the application of the disclosure regime and, possibly, misleading disclosures being made (or not made). ISDA therefore hopes that, going forward, the SFC will be more willing to provide clear guidance on the application of Part XV of the SFO (and on the application of relevant Hong Kong law and regulations generally).

7. Conclusion

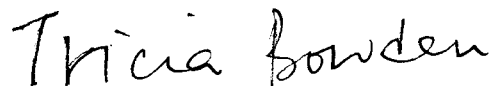
Once again, ISDA is grateful for the opportunity to comment on the proposed changes suggested by the SFC in the Consultation Paper and would be pleased to discuss the issues addressed above further or otherwise to assist in any drafting or any other way that the SFC may deem appropriate.

Should the SFC require further information, please feel free to contact Angela Papesch in Singapore on (65) 6435 7520 or Tricia Bowden at Goldman Sachs in Hong Kong on (852) 2978 1063 or Chin-Chong Liew at Allen & Overy in Hong Kong on (852) 2974 7157 ISDA would be more than happy to meet with you and your team if you would like to discuss any of the above comments.

Yours sincerely,



Angela Papesch
Director of Policy and
Head of Asia-Pacific Office



Tricia Bowden
Co-Chair of ISDA Asia-Pacific Legal and
Regulatory Committee