ISDA®

International Swaps and Derivatives Association, Inc.
24 Raffles Place
#24-02A Clifford Centre
Singapore 048621
Telephone: 65 6538 3879
Facsimile: 65 6538 6942
email: isdaap@isda.org
website: www.isda.org

BY POST AND BY E-MAIL

7 December 2007

Mr. Nigel Morris
Director, Takeovers Panel
Level 47, 80 Collins Street
MELBOURNE, Victoria, 3000
AUSTRALIA

Dear Sir,

Takeovers Panel Draft Guidance Note on Equity Derivatives

The International Swaps and Derivatives Association, Inc. ("**ISDA**"[1]) is grateful for the opportunity to respond to the request by the Australian Takeovers Panel (**"Panel"**) for submissions in relation to the draft Guidance Note on Equity Derivatives, released for public comment on 10 September 2007 (**"Guidance Note"**). ISDA believes that increased clarity as to the (appropriate) treatment of cash-settled equity derivatives will assist the efficient functioning of the market. Accordingly, ISDA welcomes the publication of the draft Guidance Note by the Panel to explain its policy and the request for comment.

ISDA's submission is set out below. This submission focuses mainly on certain high-level and international aspects and consequences of implementing a policy of the nature set out in the Guidance Note, based on ISDA's experience and observations of international markets. It is not intended to be a submission on each detailed aspect of the relevant Australian law, as we understand that the Panel will receive submissions of this nature from the Law Council of Australia and the Australian Financial Markets Association (which we believe will be consistent with ISDA's approach to this issue).

<u>Cash-settled equity derivatives are legitimate financial instruments</u>

ISDA is concerned that the Guidance Note appears to have been prepared with some element of misunderstanding as to the legitimacy of the use and role of equity derivatives in the international markets. In places, the phrasing of the discussion paper appears to evidence a view that a key role of

[1] ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. It was chartered in 1985, and today has over 825 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

equity derivatives is to avoid regulation. ISDA does not believe that this is an accurate reflection of their use in the global financial markets and is unfair to the market participants. Equity derivatives, like other derivatives, perform an important role in maintaining the liquidity and stability in the international financial markets and the consideration of any disclosure obligations which relate to them should be made with this in mind.

It is important to note that vast majority of participants in the international equity derivatives market acquire derivative positions in a listed entity purely for the purposes of making an economic profit on exiting that position or for risk management activities; not for the purpose of controlling or influencing the entity itself. Requiring these passive investors to make disclosure to the market of their economic interest does little to promote the objective of providing information on persons who control substantial parcels of shares in the entity. In fact, information on the derivative positions of these investors would in itself be both irrelevant and confusing to the market.

New rules for disclosure of cash-settled equity derivatives are not needed

ISDA understands the aims of the Guidance Note and agrees with the Panel that holders of the shares in a target company – and the market generally – should have a clear understanding of where effective control of a company's shares lies. Promoting transparency in the share market is important because the market must be appropriately informed in order to be efficient. However, ISDA is concerned that the proposals of the Panel will not lead to the desired result of increased transparency and could have the opposite effect. ISDA's concern is that, if the policy proposed in the Guidance Note is implemented, then it can only act as a burden on the market, unnecessarily reducing the attractiveness of legitimate risk management instruments (that make the market more economically 'complete').

Much of the analysis in the Guidance Note appears to be based on what ISDA considers to be a false presumption, namely that every equity derivative gives the holder of the derivative control over physical shares. In the vast majority of transactions, that is in fact not the case[2]. It is clear from the Guidance Note and the Discussion Paper that the Panel considers that the holder of a derivative may be able to exercise a degree of *de facto* control over the shares that are held as a hedge by the counterparty. This view may be due in part to the perceived nature of the relationship between the holder and the counterparty, the latter often being a dealer that will seek to retain the business of its client.

On the question as to whether a client could seek to control the entity through the exercise of votes attaching to physical shares, while the client 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. It is important in our view not to assume from isolated (if high profile) instances of what might be deemed 'unacceptable circumstances' that such instances are common, let alone the norm.

ISDA's own detailed consultation with member firms in relation to the Consultation Paper issued by the UK Takeover Panel on the same topic in 2005 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.

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[2] For example, it is common in the convertible bond market for holders of a convertible bond to write a long derivative position so that they can economically segregate the equity element of the convertible bond.

Accordingly, ISDA submits that disclosure should be required only of derivatives that by their terms grant the holder of the derivative either the right to influence how shares are voted, or a right to hold or acquire the shares[3]. ISDA understands that such derivatives are already caught by the current disclosure regime, so that no new disclosure rules should be needed for cash-settled equity derivatives.

There is no need for rules on disclosing cash-settled equity derivatives outside of a takeover context

If, on reviewing the various submissions the Panel receives, it decides to press ahead with new disclosure requirements for cash-settled equity derivatives, ISDA believes that it is critical that those requirements apply only in a takeover context; and that there should be an exemption for dealers, who may naturally acquire large positions as part of a market-making function rather than for reasons of stake-holding in a company.

Disclosure in all circumstances, whether or not the relevant shares is of a company the subject of a takeover, is excessive, particularly given that equity derivatives are primarily used to acquire "soft" interests whereby investors are not seeking to take a stake in a company.

ISDA has made enquiries of its member organisations who have advised that a regime of this breadth would impose impossible administrative burdens on their various offices around the world. Global trading firms simply do not have the reporting systems in place to aggregate and report in real time the 'notional' positions held between different offices around the world in all stocks across all markets, including Australia. It has not before this time been considered necessary to have such systems in place, because firms make a point of dealing in derivative products, so that no interest in actual shares ever arises. At the same time, the notional amount underlying those derivatives is of little or no utility for risk-management purposes[4]. To acquire and develop such systems now, on the other hand, would be prohibitively impractical[5] and could result in the withdrawal of some organisations that participate in equity derivatives over Australian shares. Of itself, such withdrawal could restrict the liquidity and transparency of pricing in the Australian market.

Market maker exemptions

ISDA's interpretation is that, unlike the position under the UK Takeover Panel regime, the Guidance Note contains no exemptions for market makers. ISDA believes that the Panel should implement such an exemption as it minimises the provision of duplicate information which can be misleading to the market. This is because, for any long position which a market maker has in a particular share in order to hedge an equity derivative it has written, it will effectively be disclosing a position that the buyer of the derivative will, under the proposed regime, also be required to disclose. Moreover, if (as is not uncommon in derivatives markets) the market maker hedges the derivative it has written not with a share purchase but with an offsetting derivative, then there would be two derivatives-driven disclosures required, while a third party would have to disclose any physical shareholding it may have acquired to hedge the derivative sold to the market maker. In fact, there is no limit to the potential length of a chain of back-to-back derivatives. Such multiple disclosures, however, are misleading, and defeat the policy purposes of any new disclosure regime.

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[3] In connection with the current UK FSA consultation on disclosures and CFDs, ISDA is exploring how deal documentation might make more explicit this legal position.

[4] Firstly not all products are 'delta-one' – the effective interest therefore is less than the notional. But, even for delta-one products, there could be offsets within the dealer's portfolio.

[5] The UK Takeovers regime was introduced without the benefit of a formal published cost-benefit justification.

ISDA believes that implementing an exemption for market makers would limit the potential for misleading impressions to be created. This exemption would also reduce compliance costs significantly for those market participants who are most affected by, and whose inclusion has the smallest value to add to, the new regime.

We understand that the intention of paragraph 60 of the draft Guidance Note may in fact be to craft such a market maker exemption. We respectfully suggest that, if this is indeed the intention, the drafting of this paragraph be reviewed in the interests of maximum clarity, and that this policy in any case be given more prominence within the proposed rules.

Netting & share basket transactions

Paragraph 31 of the Guidance Note would prevent the offsetting of long and short positions when calculating the Combined Holding, on the basis that such positions may not be exactly offsetting. However, ISDA respectfully submits that this is inconsistent with the logic of the Panel's position. If it is assumed that a long derivative gives rise to a physical holding on the part of the dealer, then it would follow that a short derivative would give rise to shorting of the stock, which will therefore be available to the market. At the very least, long and short positions in the same security between the same parties should be offset, as the reasoning set out in paragraph 31 would not apply in such circumstances.

ISDA further notes the broad definition of "derivatives", which would include share basket derivatives (where the payments under such derivative would be determined by reference to a basket of shares). Assuming that disclosure requirements are in fact applied to cash-settled derivatives, given the monitoring burden that this would entail, we believe that further consideration needs to be given to share-basket transactions, for which there would normally be a very low probability of triggering a disclosure requirement. Continuous monitoring of transactions with a minimal likely materiality for takeovers would, in our view, seem to require specific cost-benefit considerations.

Information to be disclosed

ISDA observes that the Guidance Note suggests that the information to be disclosed should include the price, entry date, derivative period, number of share, termination rights and unwind terms, the identity of the derivative writer and any material information disclosed to the market.

ISDA strongly believes that this level of information is excessive and not justified by the policy outcomes sought. If disclosure is required, then it should be limited to the number of shares, the general type of derivative contract and the 'strike' price established in the contract (as distinct from the price of the derivative instrument itself, as implied by paragraph 72 of the draft Guidance Note). Anything further is unnecessary and unworkable in a global context for firms who need to comply with the requirements of many jurisdictions, and not just Australia. In particular, the disclosure of termination rights is commercially sensitive information and need not be disclosed to the public. Termination rights typically arise as a result of financial distress events and are heavily negotiated by the parties. Such rights may be modified as a result of the relationship between the parties to the transaction and disclosing such termination rights should not be made public. (What would, of course, be highly relevant is any arrangement to acquire the shares or voting rights.) The identity of the writer is not relevant because, if they fall within the regime, then they will be disclosing anyway and, if they benefit from an exemption, then it would be inconsistent to have another party reveal their identity.

ISDA would be happy to speak with the Panel in relation to any further developments in relation to the guidelines, to clarify any issues raised in this submission or generally to discuss any future regulatory developments in the derivatives market in Australia. In the meantime, if you or your colleagues have any questions regarding our comments, please do not hesitate to contact Mr Richard Metcalfe (rmetcalfe@isda.org; +44 20 3088 3552) and Mr Bay Way Yee (wybay@isda.org; +65 6538 3879) of ISDA or Mr Scott Farrell (scott.farrell@mallesons.com; +612 9296 2142) and Mr Tim Bednall (tim.bednall@mallesons.com; +612 9296 2922) of Mallesons Stephen Jaques.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.

Richard Metcalfe
Global Head of Policy/Senior Regulatory Advisor

Bay Way Yee
Director of Policy, Asia-Pacific