

European Securities Markets Expert Group (ESME)

Views on the issue of transparency of holdings of cash settled derivatives

Adopted by ESME

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The European Securities Markets Expert Group (ESME) provides legal and economic advice to the European Commission on the application of the EU securities Directive. ESME was created by Commission Decision 2006/288/Ec of 30 March 2006 (OJ L 106, 19.4.2006, p.14).

The list of ESME members is available at:

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Executive Summary

Views on the issue of transparency of holdings of cash settled derivatives

ESME is recommending that a reporting obligation regarding cash settled derivatives is:

- > only for cash settled derivative positions, separate from the present arrangements for positions in normal shares;*
- > both for long and for short positions; no netting;*
- > only for significant positions in these particular instruments (at least 5-10%);*
- > fully harmonized and regulated on a European level.*

The background is the fact that for normal share positions, a lot of differences in national reporting obligations have been introduced and European harmonization is not within sight. ESME does not want to add further to the existing confusion and complexity and proposes a simple measure to be carried out at the pan-European level.

1. Introduction

The Transparency Directive (TD) seeks to provide a framework for “the disclosure of accurate, comprehensive and timely information about security issuers in order to build sustained investor confidence and allow for an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency. To that end, security issuers should ensure appropriate transparency for investors through a regular flow of information. To the same end, shareholders, or natural persons or legal entities holding voting rights **or financial instruments that result in an entitlement to acquire existing shares with voting rights**, should also inform issuers of the acquisition of or other changes in major holdings in companies so that the latter are in a position to keep the public informed.” (*From introductory recitals of the Transparency Directive.*)

This memo addresses the part of the TD that deals with the issue of *ongoing information* and particularly the *information about major holdings* (chapter III, section I, articles 9-16).

Recital 18 states: “The public should be informed of changes to major holdings in issuers whose shares are traded on a regulated market situated in or operating within the Community. This information should enable investors to acquire or dispose of shares in full knowledge of the changes in voting structure; it should also enhance effective control of share issuers and overall market transparency of important capital movements”.

Financial markets make increasingly use of a wide variety of market developed financial instruments such as *equity swaps, contracts for difference, cash settled options* as well as market practices like *securities lending and short selling*. Synthetic positions construed by these financial instruments make it increasingly possible to split off the economic interest from the legal interest in share positions. Legal interests give voting rights regarding the issuing company and economic interests give no voting rights. In a pure legal sense, equity derivatives settled in cash generally do not give direct access to voting rights. They can, however, be structured in a way that there is a right and/or severe economic pressure for one party involved, to transfer securities (providing for relevant voting rights) to the other party in lieu of cash settlement.

Non-notification of major holdings of synthetic positions could hamper the strategic goal of the TD to give insight in the control structure (voting position) regarding a listed company.

This paper intends to investigate the different aspects of a possible disclosure of positions in cash settled derivatives under the TD.

Paragraph 2 describes some of the recent cases where cash settled derivatives were used to build substantial positions. Paragraph 3 relates to the responses of regulators and supervisors. In section 4 some analysis is given from different viewpoints. Paragraph 5 answers the specific questions asked by the European Commission and lastly, paragraph 6 gives an overview of ESME’s previous recommendations regarding TD aspects.

2. Overview of present situation (indicative cases)

Synthetic constructions are mostly used for efficient investment management. However, some cases have drawn public interest, because synthetic constructions were used for purposes related to corporate governance issues¹:

➤ Germany:

○ Continental versus Schaeffler

July/August 2008: Schaeffler built an economic interest of 36% in Continental by entering equity swaps with some banks before it declared a public offering on the outstanding capital of Continental. Schaeffler was exempted from the launch of a mandatory bid, since it made a voluntary public offering and wanted to pay a fair price. However, this fair price was lower than would have been the case if the control position was built by normal share acquisitions instead of by equity swaps. The German regulator Bafin ruled that the build up of an economic interest by *cash settled* financial instruments does not need to be notified under current German law.

○ Porsche versus Volkswagen

October 2008: Porsche announces that it has built a direct share interest of 42,5% in its competitor Volkswagen. Porsche discloses an additional economic interest of 31,5% by *cash settled* options. There were discussions if the “free float” in shares of Volkswagen was effectively reduced to 5,8% since the bundesland of Niedersachsen held an interest of 20,1% in Volkswagen company. Market parties had not taken into account the existence of such a large economic interest with only one party. They had speculated on a share price fall and were short for about 13% of outstanding shares. The closing of these positions led to a price explosion of the Volkswagen shares. In order to improve liquidity, Porsche settled 5% of its position into cash and thereby apparently profited from the market disorder caused by itself.

○ SGL Carbon / Susanne Klatten / SKion GmbH

March 2009: according to an ad hoc announcement pursuant to § 15 WpHG dated 16 March 2009, SGL Carbon notified that the “Board of Management of SGL Carbon SE was informed that SKion, the investment company of Mrs. Susanne Klatten, has acquired an equity stake of 7.92% in SGL Carbon SE. According to their notification, SKion is interested in further purchases of additional SGL Carbon SE shares; will however remain below the threshold of 25% of voting rights. SKion has built positions within this percentage scope through derivative capital market instruments.” Different business journals (e.g. Handelsblatt, Manager Magazin) reported that SKion has followed the sample of Porsche by entering into cash settled equity swaps. On 8 April 2008, SKion notified SGL Carbon that the voting interest in SGL Carbon AG has exceeded the thresholds of 10% and 15%. At this time the stake of SKion amounted to 16.48%. All voting rights of SKion are to be attributed to Susanne Klatten.

¹ The description of cases is for a major part based on a memo on empty voting and hidden ownership by Eumedion.

➤ Italy:

○ Fiat

April 2005: EXOR, a company controlled by the Agnelli family (controlling, through IFIL, FIAT at the time with around 30% of the voting rights, through a pyramid structure) enters into an equity swap agreement for around 7% of the shares, which remains undisclosed until executed. While the originally equity swap agreement would be settled in cash, the agreement was eventually modified in August 2005 to allow physical settlement in shares. Physical delivery of the shares to the Agnelli family took place on the date in which a group of banks were executing a convertible loan agreement not being repaid in cash by FIAT and therefore diluting the Agnelli's original stake to 23%. The equity swap allowed the Agnelli family to keep their shareholdings in FIAT constant at 30% and with it the attached control rights intact without having to launch a takeover bid for the remaining of the capital. For reporting obligations, Italian law takes into account the way financial derivatives may be settled: only in cash or possibly in underlying physical instruments.

➤ Switzerland:

○ Laxey Partners versus Implenla

2007: at the AGM of the building company called Implenla, a hedge fund called Laxey Partners shows a position of 24% of outstanding shares without having notified the Swiss regulator. According to Swiss newspapers the interest was hidden by derivatives constructions such as cash settled options.

○ Victory versus Sulzer

April 2007: the industrial company Sulzer is apparently dominated by a group of Russian and Austrian investors that have an interest of 32% in the company. Part of the interest (14%) is held through a *cash settled* option construction, secretly built by an investment vehicle called Victory.

At the end of 2007, the notification and disclosure rules of the Swiss regulator were extended to include positions through put options and some other financial instruments.

➤ Australia:

○ Glencore International AG versus Austral Coal

September 2007: Xstrata Coal makes a public offering on the shares of Austral Coal. It becomes apparent that a competitor named Glencore International AG has an interest of 6,5% built by derivatives constructions that did not need to be disclosed to the public. The take over is hindered.

The Australian regulator decides in April 2008 to extend disclosure rules to include those derivatives positions that relate to more than 5% of outstanding share capital in situations where a public offer is announced or a mandatory bid must be launched.

➤ USA:

○ TCI/3G Capital Partners versus CSX Corporation

2008: hedge funds TCI and 3G Capital Partners try to appoint 5 (non-) executives in the board of the railway company CSX Corporation. They hold a direct interest of about 9% and a hidden economic interest of 14% through total return swaps. The hedge funds had the possibility to convert these swaps at all times to direct share positions. Eventually 4 of the 5 nominated candidates were appointed. Although these hedge funds violated the disclosure regulation, of the Securities Exchange Act, the requested nullification of the voting position was not granted. Such a decision could only be initiated by the SEC or the Court of Justice.

3. Actions taken by some regulators and (changes of) regulation elsewhere

Some member states have decided to generally extend major notification requirements to cash settled derivatives or are planning to do so.

The United Kingdom has introduced a new regime that will require the disclosure of (gross) long positions on cash settled derivatives from 1 June 2009 onwards. It requires reporting once the threshold of 3% has been reached, aggregating both the derivative transactions and any actual holdings of the voting shares.

The Dutch ministry of Finance will, in co-operation with the Netherlands Authority for the Financial Markets, consider whether and if so, how the legal substantial holding disclosure provisions should be extended to cash settled derivative positions.

The regulator in Germany has experienced a lot of public pressure to modify regulation. Finance directors of some large German listed companies have asked the German regulator to change notification rules.

The Swiss regulator has extended the scope of notification rules at end of 2007. Disclosures on cash settled derivatives only are seldom, in many cases such disclosures are done in connection with disclosures on other participations (shares) in the respective companies. The disclosures have become more complex by expanding the disclosure requirements to cash settled derivatives, but the disclosures contain more information.

In Italy, the national authority Consob has recently issued a public consultation on the topic.

Other countries have extended public notification of large derivatives positions related to equities, during times of take over situations.

4. Analysis

4.1 Disproportional relations

In normal circumstances there is proportionality between the voting power related to the share interest and the capital invested in a stock-exchange listed company. However, situations may arise where there is a disproportional relation between control (legal interest) and economic interest. Financial instruments and market practices as developed in global financial markets, have made it easier to split the economic interest off from the legal interest in a company.

- legal interest > economic interest, giving voting rights in corporate governance situations (“empty voting”)
- economic interest > legal interest (“**hidden ownership**”)

This report relates mainly to the situation of hidden ownership. Hidden ownership may have negative side effects, for the shareholder as well as for the issuing company. Some of the possible negative consequences are:

- no efficient pricing in capital markets due to insufficient information
- no transparency on large holdings, on large transactions, on possible conflicts of interest and on free float of a share
- avoidance of the launch of a mandatory bid at an equitable price; no take over premium and no real exit for minority shareholders

It is for these reasons that institutional investors propagate the proportionality principle: the control attached to a share interest in a stock exchange listed company should be proportional with the capital interest in the share position.

4.2 Reasons for existence of cash settled derivatives

In the normal course of events equity derivatives settled in cash are used primarily for economic and financial interests rather than for legal interests and they do not provide direct access to voting rights in the companies' capital. When derivatives are settled in cash the counterparties to the derivative transaction do neither acquire nor deliver shares or corresponding voting rights at maturity of the transaction.²

Since the early 90's cash settled derivatives have become a market standard for institutional as well as for retail investors due to the fact, that most investors are only interested in the price performance of the equity and do not intend switching into an equity cash position after the derivative instrument has been expired. Cash settlement increases efficiency and reduces risk in settling a transaction at maturity:

- No need for the buyer of a call option to pay the strike (purchase) price of the equity to the seller and wait for the delivery of the equity. No risk for the seller of a call option regarding the due payment of the buyer (contrary action in case of a put option).

² Even when settled in cash, the potential seller may hold a certain or the full number of shares for hedging purposes throughout the lifetime of the transaction (“dynamic hedging”). In case of large positions in an illiquid share the seller might even have an interest in delivering shares instead of being forced to unwind the hedging position at the settlement price, which is normally done when settling in cash.

- Any risk reduced to the timely transfer of the price difference from the seller to the buyer of the option in the case of an intrinsic value.
- Almost no cost, time delay or foreign exchange exposure in executing a cash settlement, especially in the case of cross border transaction. No need for the receiver of the equity in a separate sale, if he does not intend to hold the equity.
- No split of the redemption value into a cash component and the equity due to fractions, for example subsequent to corporate action in the equity.
- No minimum requirement for exchange ratios and trading sizes, for example in the case of very expensive equity.
- In the case of index investments cash settlement is a pure necessity, as physical delivery only makes sense for high transaction values due to the obligation to otherwise deliver 20 or 30 different stocks.
- Different tax treatment of physically and cash settled derivative transactions in some jurisdictions.

The clearest example for tax treatment is the use of contracts for difference (CfD's) that were invented to avoid payment of so called "stamp duties" in the UK market. Also in Germany economically identical structures are taxed differently due to the type of settlement. Other instruments were developed to create a quick access to specific market segments ("exposure").

A general characteristic of derivatives is that these financial instruments are mostly being used for risk management purposes; e.g. by large investors to spread and diversify risk in an investment portfolio. Further, as cash settled products overcome a lot of disadvantages to investors, cash settlement might have helped to improve liquidity in certain financial markets. Types of derivative products used in cash settlement include the following (the list is not extensive)³:

<i>types of instruments</i>	<i>Specific reasons for cash settlement</i>
equity swaps	
contracts for difference	For stamp duty reasons
Options	
Forwards	
convertible bonds	
exchange traded funds (ETF's)	The underlying consists of a basket of stock which makes physical delivery almost impossible.
exchange traded options and futures contracts	

³ The table lists some of the most commonly used instruments to acquire exposure to equities. Since some of these instruments are listed, standardized and sold heavily in the retail market and it may be difficult to initiate reporting requirements for these products. Any proposed regulatory scheme should respect the boundaries of the system and the boundaries of all financial instruments available.

It can be concluded that for the majority, positions in these instruments are never intended to hide ownership and/or make unethical price gains.

However, there might be an issue of “creeping control” when cash settled derivatives positions go across a certain threshold; such positions could effectively imply an option to acquire the underlying equity with voting rights. For a possible link with such voting rights two things are important:

1. The position needs to be meaningful.
2. There are additional arrangements between the investor and the broker dealer/investment bank to acquire access to legal interest, i.e. voting rights; these arrangements can be explicit or implicit, or, alternatively, the instrument is construed in a way that economic pressure results in factually securing the delivery of voting securities.

4.3 Importance of the Transparency Directive in securities legislation

The TD is related to other pieces of EU regulation, e.g. the disclosure standards of the TD are used in the Take over Bid Directive. In some Member States the implementation of the TD is inspired by the need to prevent market manipulation as referred to in the Market Abuse Directive.

In instances where either arrangements on the exercise of voting rights are concluded alongside the cash settled equity derivatives transaction or such transactions are structured to provide for severe economic pressure for one party to provide the other party with relevant voting securities, situations may arise where the derivatives transaction may result in making it possible to exercise voting rights in the shares of companies which are the underlying assets of the derivatives transaction. These cases have occurred in the recent past and are usually structured in a way that they cannot be seen legally as abuses of the current transparency requirements in force in EU member States. These cases might come within the scope of the Market Abuse directive. Since the objective of the Transparency Directive is to give to the markets a true picture of the transactions regarding major holdings taking place in the markets and to assure that investors can act on a fully informed basis, there may be good reason for amending the current regime to allow for adequate transparency.

Therefore, although some of the situations that have raised concern could give rise to market abuse issues, it seems that the overall conceptual issue has to do with the Transparency Directive. Whilst the acquisition of these interests can be associated with behavior that might be at least akin to market abuse, it seems that the policy reasons behind requiring disclosure are wider. Market abuse in this context could be seen as only part of a wider transparency issue. The issue of transparency is not just one for other market participants, there is also the question of an issuer and its management understanding who has an economic exposure to the company and who might therefore, directly or indirectly, be able to exert influence over the company. In our view, this is not just a market abuse issue, it is a wider issue of market transparency and we think that a proper high enough threshold, uniformly applied across Member States would be an appropriate way of dealing with both the transparency issue and market abuse concerns. The mere existence of reliable data could at least assist when investigating possible cases of suspected market manipulation.

4.4 Possible amendments of the TD

Improved notification via TD could give access to factual information. One of the questions behind the TD is what kind of transparency is needed and by whom. A possibility would be to just ask for the transparency of the instruments, as such, without the link to the potential control of the shares. This would imply that all large positions are reported, whether in direct instruments or in synthetic constructions. It is left to the receiver of the information to draw conclusions on the reasons behind the

positions. Any possible relation to mandatory take over bids or market manipulation behavior is for interpretation and therefore not direct.

Some countries have introduced the reporting of a “declaration of intention” for large positions; e.g. held for trading or held for control. This could help to interpret large positions in cash settled derivatives (provided they are included into the reporting regime of the TD). However, amendments of the TD to include such details may not give the desired effect; recent cases show that the question whether a party wants to disclose significant holdings, depends on the intention behind the building of these positions. The investment community is somewhat skeptical about the effectiveness of declaration of intentions. Besides, there is the fundamental concern that there are no objective criteria to judge investors’ intentions (you cannot blame people on their intentions).

It has been suggested that positions in cash settled instruments could be reported separately (not counted together with (real) voting positions) only to the supervisory authority.

If only economic interests were at stake in the cases described above, and authorities are looking for solutions to prevent further similar cases to happen, it could be that more information given to the market might be a problem. The market could receive a lot of information that it would not be able to assimilate, given the very short time frame in which most or all of the recent cases have taken place. It would seem that the information on cash settled derivatives should be better used if reported to a supervisory authority. The supervisor would be best placed to decide if disclosures should be in the interest of the market at large. Supervisors should probably be advised to upgrade their monitoring capabilities so as to be better placed to detect abnormal transactions taking place in the market and react consequently vis-a vis some market participants.

On the other hand, reporting only to the supervisor and not to the market at large has its conceptual drawbacks. The reason is that the investors are the ones who need to be protected in line with the aims of the TD. One of the goals of the TD is to assure efficient pricing in capital markets. Without this, trust in the markets, which is already damaged by recent developments, will disappear – with all negative consequences on the markets as such. The fact that there is fear for overload of information to the market or damage to the competitive situation for global investment banks in the market of cash settled derivatives, could be taken into consideration as far as there are legitimate concerns. Relevant exemptions for reporting of trading positions of financial institutions and market makers could be given; such exemptions are proven already under existing law.

The tendency to lower the reporting thresholds for normal share positions has increased the administrative burden related to the TD. It should be avoided to further deteriorate the reporting burden by requesting the positions in cash settled derivatives as normal reporting of large holdings under the TD, especially in those countries where the reporting threshold has been set at a lower level. We would want to avoid overloading the market with too much information and adding extra complexity. Since most of OTC derivatives positions are used for other purposes than to gain control, we would recommend disclosure for higher thresholds only. This could also support investigating possible market abuse situations. This argument is especially valid, if no sustainable concept is in place which avoids double counting, allowing the total number of the reporting to exceed 100 per cent of the share capital.

Article 10 of the TD mentions the application of notification requirements to entities that hold voting rights under an agreement with the ultimate investor. In a very indirect way this article could perhaps be linked to “control incidents”. Further, article 13 of the TD related directly to the notification of financial instruments that result in an entitlement to acquire voting rights under a formal agreement. Because it could be very difficult to show that there was economic pressure by the transaction party to deliver voting securities, it has been suggested to connect a reporting obligation to the existence of a

contract that allows for *the possibility* of settlement in physical shares.⁴ However, in the cases described in this paper, there usually was no specific agreement on voting; it is not that often that there is actually a formal right to require the delivery of voting securities. Yet in reality there is often an expectation on the part of the acquirer that the counterparty to the trade would be able to deliver the underlying stock if asked to do so. The mere aspect of the commercial relation gives an incentive to the bank to listen to the opinion of the underlying client and, finally, to deliver voting securities in lieu of cash settlement.

4.5 Operational and implementation issues

It has proven that the interpretation of use of cash settled derivatives for control differs among member states. In practice, if we take the example of France, Germany and the UK, these are 3 different ways of implementing the Transparency Directive, whereas the tool to monitor positions is one and provides for the same functionalities. In the UK, from 1 June 2009 all derivatives positions are taken into account in the calculation of the 3% threshold. In France only positions in shares are taken into account in the reporting threshold, and the derivative instruments are disclosed when their amount is larger than 5%, expressed in cash. In Italy there are two separate thresholds of 2%, one for equity, the other for derivative, which do not sum up. Lastly, in Germany, the minimum threshold for notification of normal voting rights is (and was) 3% and for instruments that give right to acquire voting rights is 5%. Both types of instruments must be counted together and notified if (counted together) reach a minimum of 5% (then 10, 15, etc).

Other features of cash settled instruments introduce differences in the monitoring. For instance, in the UK positions in options are taken delta netted, whereas in France the nominal amount is taken into account without any netting of long and short positions of options upon notification that a threshold has been reached.

The argument of administrative costs is often used as a disadvantage of increased reporting requirements. However, we would state that the present differences in implementation of the TD in all member states truly leads to administrative costs for asset management companies operating on a cross border scale. In order not to get caught in these complexities, we are pleading for a reporting obligation that is general and harmonized at EU level and therefore separate from reporting of normal shares.

Recently ESME published a paper on the experiences with restrictions on Short Selling. The paper presents a.o. the positive effects of short selling for the functioning of orderly markets. However, it also states "There is a potential for giving false or misleading impression as to the supply of shares on offer for sales." This statement implies that notification of large negative positions would increase transparency of the market in a certain share. Expanding on this issue, the same argument applies to large positions in cash settled derivatives; these should be reported so that the information can be linked to long or short positions in the actual share.

⁴ If pursuing this route, it should not be overlooked to make a relation to standard ISDA documentation for OTC derivatives, that however, was drafted just the other way around: "If no physical settlement possible, than cash settlement takes place".

Conclusive, we would like to recommend separate disclosure of long positions and short positions in cash settled derivatives, if these positions exceed a high enough threshold (5% or 10%)⁵. Netting of positions should not take place.

5. Specific questions raised by European Commission

The Commission services would like to hear the opinion of the members of ESME on the following points:

- Are there any figures relating to the use by the market of cash-settled equity derivatives as compared to the overall trading in equities?

Besides the BIS figures, we are not aware of any other statistics.

- Is there any tendency in the market to have recourse to cash-settled equity derivatives in order to avoid disclosure requirements? Did the actual financial crisis change this tendency?

Synthetic constructions are for the majority not used to influence voting behavior or to carry out a creeping increase of control on a listed company. Generally speaking, synthetic constructions contribute to risk hedging and efficient pricing in capital markets. They increase investment possibilities for professional investors and help to improve the risk profile of their investment portfolios. In some markets there are legitimate reasons that pre-date the financial crisis for the use of cash settled equity derivatives; particularly in those countries which have a stamp duty transfer tax on the actual transfer of equities (being the UK and the Republic of Ireland).

However, recent cases demonstrate that there may be a deliberate intention by some strategic investors to take the space to maneuver as provided in regulation. Meaning, instruments that originally are construed for liquidity or hedging purposes are factually being used to acquire material stakes in companies at a price that is influenced by circumventing existing transparency rules. There is no evidence that the financial crisis will change this behavior; presently there is little activity in mergers and acquisitions to substantiate this statement.

New cases may rise, when the M&A market emerges from the economic downturn. However, we would expect banks in the future to be more reluctant when being asked to participate in a “stake building” scheme making use of cash settled derivatives and designed specifically to avoid disclosure to the market.

- Could the non-disclosure of the cash-settled equity derivatives positions be problematic with regard to market transparency?

The original objectives of the TD, such as insight in voting positions in listed companies and the contribution to efficient pricing in capital markets may be undermined by synthetic constructions, such as positions built by cash settled derivatives. In our view this will only be the case if substantial positions are at stake. It does not seem worthwhile to start reporting all transactions and positions in synthetic instruments. A meaningful reporting process would link normal share positions with cash settled instrument positions. In our view this would only be required for positions above a certain, large enough, threshold. As a principle, all large positive and large

⁵ One member disagreed with the conclusion that public disclosure requirements should apply equally to short positions.

negative positions (*long and short positions*) in physical and in synthetic instruments should be reported.

- In your view, could the provisions of the Transparency Directive, namely Article 10(g), be used in certain circumstances in order to require disclosure of cash-settled equity derivatives positions?

Article 10 (g) states that notification requirements shall also apply to a natural person or legal entity to the extent it is entitled to acquire, to dispose of, or to exercise voting rights in case the *voting rights are held by a third party in its own name on behalf of that person or entity*. In our view, this clause was not introduced for large positions in cash settled derivatives, but for the market practice of custodians or for situations of “at arms length” investment management. The provision is rather narrowly framed to support a widening of disclosure rules to cash settled financial instruments.

- Should there be a systematic disclosure of cash-settled equity derivatives positions or should it be limited (i.e. to cases where the derivative was entered into in connection with control transactions)?

There is a wide spectrum of instruments that can lead to manipulation of economic and legal interest in a listed stock. It may be difficult to draw the boundary between which instruments to include and which to exclude. Since most of these instruments are used to increase liquidity or decrease market risk, many positions may not qualify for disclosure within the context of the TD. To overcome the reporting burden, it has been suggested to report only during “times of corporate events”. For instance: disclosure during offering periods only. We doubt whether it will give the desired results and expect it to be operationally complex. E.g. in situations of creeping control, there is not yet a take over situation, but the market may need to be informed. Further, it is also contemplated to report only in cases where there is a contract that allows for physical settlement instead of cash settlement. This may not be sufficiently effective, because directly or indirectly, there is often an expectation on the part of the acquirer that the counterparty to the trade would be able to deliver the underlying stock if asked to do so.

In our view it would be preferable to disclose all derivatives positions of mostly used instruments irrespective of possible intentions of investors. Systematic reporting of large positions in cash-settled equity derivatives positions will concentrate analysis of possible control situations and avoid too many administrative costs. The disclosure obligation threshold for cash settled derivatives should not be set too low (at least 5% or 10%) and should be uniform and harmonized across Europe (including the means, the timing and the recipients). In order to achieve true transparency on the *potential* of hidden ownership, we recommend to take large positive and large negative positions separately and not on a net basis. Finally, a harmonization with reporting obligations in other global markets should be aimed at.

The reason for opting for a uniform reporting obligation of large positive and negative positions in synthetic instruments, separate from the reporting of positions in the underlying shares, stems from the reality that the reporting arrangements for those positions is diffuse and continues to be not harmonized. Although the ultimate goal could be aggregation of share and derivatives positions into one reporting requirement, ESME has concluded that it cannot be implemented in a fully harmonized way within the foreseeable future.

- Is Commission action needed in this field?

The Transparency Directive (TD) seeks to provide a framework for “the disclosure of accurate, comprehensive and timely information about security issuers in order to build sustained investor confidence and allow for an informed assessment of their business performance and assets. This

enhances both investor protection and market efficiency.” Since the objective of the Transparency Directive is to give to the markets a true picture of the transactions regarding major holdings taking place in the markets and to assure that investors can act on a fully informed basis, there may be good reason for amending the current regime to allow for adequate transparency.

6. Previous advice by ESME

The rules in the TD on major holding disclosures are relatively old in their conception. An ongoing review of the directive is taking place. Further, an external study by the Commission on the cost of compliance with the TD is taking place. One of the issues addressed is the costs for asset managers complying with several national disclosure rules at the same time.

ESME has contributed to the review with several specific reports: the group has investigated several aspects of the ongoing information as required by the TD and possible links with related market practices in Europe and beyond. Papers were delivered on the operational differences in notification processes across Europe, on the different definitions of dis-aggregation, on acting in concert and on the ban on short selling.

1. In its first report on the TD (end of 2007), dealing with the reporting procedures and securities lending, ESME concluded:
 - the rules relating to the notification of major shareholdings are complex and often difficult to adhere to in practice for reasons including the nature of the holdings that count towards the disclosure requirement, the thresholds at which holdings are required to be disclosed and the time period in which a shareholder has to make the disclosure and to whom; and
 - the understanding and consequences of securities lending varies across the member states.

The report also makes a **remark on derivatives positions**: “Requiring the disclosure of pure economic interests in the capital of the company, including contracts for differences and other cash settled products, is likely to lead to significantly larger number of disclosures, and an increase in complexity of the rules, while potentially obscuring the information that is most material to investors, namely actual control over voting rights. Even extending the disclosure obligation to include options or other rights which, if exercised, could result in the acquisition of voting rights significantly increases the volume of disclosures and leads to reporting of multiple interests in the same shareholding. A netting regime across all Member States so that only those truly holding the voting rights are required to make a disclosure would add to market clarity through the avoidance of excessive disclosures being made and, in particular, avoid the numerous disclosures that can result from stock lending chains” (*explained further in the report*).

Since then, developments have taken place. Some member states have seen several cases where cash settled instruments obviously have been used to acquire material stakes in companies without showing this to the market. There seems to be a need to reconsider this earlier view.

2. The memo on acting in concert of December 2008 refers to a particular issue in the TD; the definition of acting in concert lies outside the scope of this paper. However, in the context the view is expressed that minimum harmonization directives give wide room for interpretation by Member States. “This may lead to great uncertainties in market behavior, especially where cross-border

shareholdings are concerned; in many cases investors are not sure of the consequences of their behavior". The memo gives the preliminary indication that the compliance to the obligation to disclose major holdings should be as standardized as much as possible.

3. The paper with ESME's position on short selling (March 2009) describes the experiences on the short selling ban. It states that short selling can be used abusively (particularly where naked short selling occurs) and can contribute to disorderly markets. These types of risk are considered insufficient to warrant a ban on short selling. However, since short selling is a market practice that could affect the control position of the investor involved, there may be a ground for reporting large negative positions or netting short sales with positive major holdings. Indeed, the report states: "Less interventionist measures (than a ban on short selling) may be more effective in addressing potential concerns regarding short selling (e.g. in the Porsche/Volkswagen situation) and increasing market transparency. That one we would suggest for consideration is that of the disclosure of short selling activity. This could be achieved on an aggregated and anonymous basis and may provide useful information to both regulators and other market participants. However, prior to any implementation of rules, more detailed research is necessary to allow for a consistent application". The report gives 7 topics to be considered when requiring disclosure of short selling positions.
4. ESME also adopted a report on different rules for disaggregation in EU financial services legislation; in the appendix two examples of optional regulation in the TD are given for holders of voting rights or for member state regulators. The report states: "From a market perspective, the result would also be corrupted, because in substance similar situations would be treated differently in terms of transparency. We recommend that these issues are considered further".

The main conclusion that can be drawn from the reports mentioned above is the fact that the logicity of the use of the TD reporting system for "ongoing information" is not clear. There is a need for increased transparency of major holdings, whether in outright shares or via cash settled derivatives. Also, the implications for voting positions by the disguising influence of market practices like short selling or stock lending need to be taken into account. The Transparency Directive should be redrafted for the section of *ongoing information* into a maximum harmonization directive that must take into account Community wide definitions, calculation methods and reporting lines. To avoid large costs for investors and issuers, fairly high thresholds must be set and reporting to one single point in the EU (who then can provide relevant information to the market) should be contemplated.

Finally, there is a need for a worldwide negotiation of whatever additional disclosure requirements would be decided at EU level. European requirements in this area should be construed as global regulatory measures. Otherwise instruments traded in Europe today could be traded outside of Europe (off-shore) tomorrow; in jurisdictions where disclosure requirements would be less stringent.

Annex 1: The case for harmonization

The TD itself makes several references to harmonization and standardization.

The Transparency Directive is drafted under the principles of the Financial Markets action plan and explicitly seeks for a high level of investor protection throughout the Community with the aim to enable the removal of barriers to the admission of securities to regulated markets within a Member State, i.e. to complete the internal market (recital 7 and 8). Investor confidence should be ensured through equivalent transparency throughout the Community (recital 41).

The text of the TD states that “greater **harmonization** of provisions of national law on periodic and ongoing information requirements for security issuers should lead to a high level of investor protection throughout the Community” (recital 5).

In recital 29 it says: “Increasing cross-border activities require improved cooperation between national competent authorities, including a comprehensive set of provisions for the exchange of information and for the precautionary measures. The organization of the regulatory and supervisory tasks in each Member State should not hinder efficient cooperation between the competent national authorities”. It continues to explain level 2 measures and states in recital 35; “Technical implementing measures for the rules laid down in this Directive may be necessary to take account of new developments on securities markets”. The Commission should accordingly be empowered to adopt implementing measures after consulting the European Securities Committee. In exercising its implementing measures in accordance with the TD, the Commission should respect the following principles:

principle	assessment in case disclosure of major holdings of cash settled derivatives takes place
the need to ensure confidence in financial markets among investors by promoting high standards of transparency in financial markets	+++
the need to provide investors with a wide range of competing investments and a level of disclosure and protection tailored to their circumstances	-/+
the need to ensure that independent regulatory authorities enforce the rules consistently, especially as regards the fight against economic crime	n.a. (= condition)
the need for high level of transparency and consultation with all market participants and with the European Parliament and the Council	n.a. (= condition)
the need to encourage innovation in financial markets if they are to be dynamic and efficient	–
the need to ensure market integrity by close and reactive monitoring of financial innovations	++
the importance of reducing the cost of, and increasing access to, capital	++ (if implemented in standard way)
the balance of costs and benefits to market participants on a long term basis, including small and medium sized businesses and small investors, in any implementing measures	++ (if implemented in standard way)
the need to foster the international competitiveness of Community financial markets without prejudice to a much-needed extension of international cooperation	–

the need to achieve a level playing field for all market participants by establishing Community-wide regulation wherever appropriate	+
the need to respect differences in national markets where these do not unduly impinge on the coherence of the single market	n.a. (present differences in disclosure do impinge on the coherence of the single market)
the need to ensure coherence with other Community legislation in this area, as imbalances in information and a lack of transparency may jeopardize the operation of the markets and above all harm consumers and small investors	++ (if implemented in standard way)

Annex 2 – Members of ESME

The members of ESME do not represent their respective firms but participate on an individual basis to contribute their expertise and understanding of financial markets to the European Commission. ECB and CESR representatives are observers at the meetings of ESME.

Chris Bates - Clifford Chance *

Mats Beckman – SEB

Margaret Chamberlain - Travers Smith *

Fabrice Demarigny – Mazars

Carmine DiNoia – Assonime *

John Foyle

Gianluca Garbi – Dresdner Kleinwort

Wolfgang Gerhardt - Bank Sal. Oppenheim jr. & Cie.*

Jane Hiljkjær Lauridsen - Danske Bank

John Holland

Karl-Peter Horstmann - RWE Trading

Magdalena Jagodzińska - KBC Towarzystwo Funduszy Inwestycyjnych

Henny Kapteijn - pension fund industry* (rapporteur)

David Meagher

Javier Mendez Llera - BBVA Asset Management

Roger Müller - Deutsche Börse *

Els Ponnet - Fortis Bank

María Gracia Rubio de Casas - Baker & McKenzie

Florence Sirel - BNP Paribas *

Pamela Thompson - Eversheds

** Participants in the ESME sub-group on the Transparency Directive.*