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VIA INTERNET: www.cesr.eu

Committee of European Securities Regulators

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STRICTLY CONFIDENTIAL

March 31, 2010

Re: CESR proposal to extend major shareholding notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares.

Ref.: CESR/09 – 1215b

Ladies and Gentlemen:

This letter is respectfully submitted in response to the request of the Committee of European Securities Regulators ("**CESR**") for comments on its consultation paper, titled "CESR proposal to extend major shareholdings notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares", released in February 2010 (Ref.: CESR/09-1215b) (the "**Consultation Paper**").

We appreciate the opportunity to respond to the questions raised by the Consultation Paper relating to the proposed extension of the disclosure regime provided by the Transparency Directive[1] to instruments discussed in the Consultation Paper. Such instruments may generally have a similar economic effect to holding shares underlying such instruments or entitlements to acquire such shares and include, among others, contracts for difference, "long" equity swaps, "long" call options, "short" put options, and overall create a synthetic "long" position in the underlying equity securities (collectively "**Equity Derivatives**").

Latham & Watkins LLP is a global law firm with over 2,000 attorneys practicing in 29 offices around the world, including several in the European Union – London, Paris, Milan, Rome, Madrid, Barcelona, Frankfurt, Munich and Hamburg. In the course of our practice in those offices, as well as in our practice in the United States, the Far East and the Middle East, we represent numerous clients engaged in several types of Equity Derivatives businesses and liaise with governmental and self-regulatory bodies on various initiatives. In addition to major global financial institutions, commonly recognized as "major Equity Derivatives dealers", we represent multiple "buy-side" entities in the Equity Derivatives market (*i.e.*, corporate issuers, private equity and venture capital funds, hedge funds, sovereign-wealth funds, governmental entities and others). We hope that, on the basis of our experience and access to various market participants, you may find our reflections and responses to the Consultation Paper helpful.

As a general matter, we strongly support CESR's initiatives in the field of harmonization of existing disclosure regimes and establishing a uniform pan-European regulatory framework. We also

[1] Directive 2004/109/EC; *cf.* Official Journal L 390/38, 31.12.2004.

believe that any decision about a possible new European disclosure regime should be grounded in a deep and comprehensive cost-benefit analysis – as already done in other fields (*e.g.*, the debate about the reform of the so-called "one-share-one-vote principle") – in order to assess and balance the reasons, functioning and objectives of the Equity Derivatives market and the reasons and objectives of any additional regulation.

Derivatives in general, including Equity Derivatives, span a monumental business area which is vital to the efficient functioning of the global economy. Practical application of Equity Derivatives in areas like capital raising, financing, risk management, hedging, pricing efficiency, among others, have provided the world economy with immense benefits. With that in mind, it is somewhat unfortunate that on occasion the perception and regulatory attention afforded Equity Derivatives has focused on a small number of fringe cases where alleged abuses have been marginally related to Equity Derivatives themselves. In addition, certain arguments quoted in the Consultation Paper and underlying the reasons behind current regulatory initiatives, like the "systemic risk" effect of equity derivative disclosure, the possible control over the voting rights attached to the underlying shares held as hedge and the distortive effect of Equity Derivatives on pricing of equities (for example, "free float" arguments), have so far found very little support in empirical studies conducted on these topics.

As such, given the fact that the cases which prompted the current debate highlighted in the Consultation Paper are few and interpretation of facts surrounding them continues to be subject to dispute, when the validity of such purported issues is analyzed in light of the volume and complexity of derivatives transactions carried out worldwide on a daily basis and the phenomenal benefits conveyed by these businesses, we believe that, prior to any official recommendation with respect to additional regulation, CESR should carefully assess the real nature of any allegedly abusive practices and the most efficient way of addressing them. In addition, it is inevitable that while any "comprehensive" regulation is likely to result in significant implementation costs that are likely to affect not only major financial institutions but also other market participants (*i.e.*, corporate issuers, hedge funds, private equity funds or other investment vehicles). It is also likely that regulation that is not properly calibrated might lead to confusing or excessive regulation that would likely frustrate the policy goals underpinning current efforts. Accordingly, we believe that any initial regulatory analysis should primarily focus on whether any perceived marginal abuses could not be more efficiently addressed by other measures, for example a more vigorous enforcement by the EU supervisory authorities or narrowing the rule-making focus to specific areas where such perceived abuses occur.

If, however, the outcome of this preliminary assessment would result in recommendation of additional regulation that would extend the reporting notification regime to Equity Derivatives, we believe that, according to the guiding principle of subsidiarity as set forth in Article 5 of the Treaty establishing the European Community, CESR, as already effected with respect to short selling issues, should lead the process and promote a harmonized pan-European approach to the regulation of Equity Derivatives disclosure. Such proposed approach, in addition to heavy reliance on a comprehensive cost-benefit analysis, should be proportionate and should not go beyond what is strictly necessary to achieve the objectives identified through a properly calibrated cost-benefit analysis. This approach could help limit costs and market and legal inefficiencies by eliminating inconsistent national regimes, particularly given the various national initiatives already in place (*i.e.*, UK and France) or the ones in planning or implementation stages (*i.e.*, Italy, The Netherlands and Portugal).

Keeping in mind the general overview above on Equity Derivatives' role in financial markets, in the following paragraphs we will address the specific questions raised in the Consultation Paper.

REPORTING OF SHARE DERIVATIVES

Q1. Do you agree with CESR's analysis of the issues raised by the use of instruments of similar economic effect to shares and entitlements to acquire shares?

As already mentioned in the introduction, we do believe that any decision about the introduction of any new disclosure regime should be grounded on a thorough cost-benefit analysis. It seems that the "benefit" that the Consultation Paper seeks to achieve is the remediation of abusive practices relating to certain practices effected in the context of takeover activities and shareholder activism. Although the reasoning and cases allegedly supporting these "empty voting" cases may seem compelling, we believe that at this time there is little, if any, empirical data supporting these arguments. We believe that CESR should take a close look at the analytical sample providing the basis for this regulatory proposal and closely examine the cases used in its review.

For example, there is no evidence that the use of Equity Derivatives has had or might have any role in past or potential systemic failures of the financial system. Similarly, there is no data supporting any conclusions that the use of Equity Derivatives has had a negative effect on "public float" and other trading patterns in the underlying equity securities. Additionally, the analytical link between a significant economic interest and the use of that interest to "influence" the issuer is tenuous at best. This argument is undermined by the lack of any evidence that the holder of a long synthetic instrument is able to influence the voting of the underlying shares held by the financial institution holding the relevant hedged position. To the contrary, all major financial institutions have policies in place obviating the possibility of such influence.

As a result, if the real concern underlying the regulatory initiative highlighted in the Consultation Paper is to address issues relating to questionable practices like settlement modifications and activist shareholders' behavior, a proper solution should not lie in comprehensive disclosure regulation, but in enforcement of current rules in light of "evasive" and "tacit" dealing, "ownership" monitoring and overall concepts applicable to "takeover" rule and policy-making. We appreciate the logic and support CESR's initiative to address the issue of above-mentioned abuses and the concept of selective extension of disclosure obligations to the limited number and type of "questionable" Equity Derivative arrangements. Undoubtedly, schemes designed to conceal shareholdings or indirectly influence voting rights should be subject to enforcement and disclosure, given their possible effects over the issuers' corporate governance and, more generally, because of the pricing distortions that, upon certain conditions, could possibly result from "concealed" holdings. Notwithstanding the foregoing, we believe that Equity Derivatives may be mere tools assisting in improper market behavior which can be effected in a variety of other ways. Accordingly, we would urge CESR to keep in mind that the above transactions constitute a *de minimis* portion of the Equity Derivatives business which, despite a certain criticism raised in connection with the recent global financial crisis and the current difficulties affecting some EU member states, continues to play an essential role for the functioning of the financial markets worldwide.

Having said that, as an example, it is worth pointing out that in the Porsche/Volkswagen case cited in the Consultation Paper, the German Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, the "**BaFin**") has conducted investigations for alleged market manipulation in connection with certain practices in the attempted takeover of Volkswagen by Porsche. While ruling that some practices Porsche engaged in the attempted takeover of Volkswagen caused "*a high increase in the share price, allegedly because of hedge funds rushing to cover their short positions*" (see note 24 in the Consultation Paper), BaFin has consequently made clear that such practices are more properly addressed as market manipulation. Other than that BaFin has not yet engaged in rulemaking initiatives in order to expand regulations to financial instruments "*with similar economic effects to those financial instruments under Article 13 of the Transparency Directive*".

Similarly, in the CSX case quoted in the Consultation Paper, the New York federal court ultimately found fault with the involved hedge funds on the basis of violation of existing regulations relating to "beneficial ownership" disclosure. The court, however, found no evidence of any wrongdoing by the banks, any inappropriate arrangements with respect to the voting of shares underlying the swaps between the funds and the banks or proclaimed any overall shortcomings in the current disclosure system. It is worth noting that swap arrangements, which were partially at issue in the case, had been disclosed as a result of the hedge funds' crossing of threshold triggering comprehensive disclosure. The ultimate failure of the funds, as adjudicated by the court, did not result from the alleged abuses by the funds and the banks taking advantage of the hedge positions accumulated by the banks, but by the funds failure to timely report their positions as a result of tacit agreements between two hedge funds involved in the case. In addition, the U.S. Securities and Exchange Commission intervened in the cases, supporting the position of the defendants and that of other interested parties, mostly banks, acting through industry organizations like the International Swap and Derivates Association and Securities Industry and Financial Markets Association.

In summary, we believe that current regulatory proposals, although laudable, would lead to unnecessary over-regulation in light of a more specific policy objective and are likely to prompt dramatic implementation costs. In our opinion, such over-regulation should be avoided at this time and any recommendations should be based on proper empirical studies and not on reactions prompted by media and political analysis of certain news items. In particular, requiring disclosure of Equity Derivatives entered into for the aforementioned legitimate purposes would be inefficient and misleading and would likely result in high compliance and operational costs for all market participants and a possible decrease in market efficiency, because the market may not be able to process the volume of information provided and identify relevant disclosure. In light of the above, should the outcome of the proposed preliminary cost-benefit analysis be that a new disclosure regime is necessary, we believe that such regime should not reach beyond what is strictly necessary to achieve the objectives of the additional regulation and should provide exemptions for Equity Derivatives entered into for legitimate purposes.[2]

BROAD DEFINITION

Q2. Do you agree that the scope of the Transparency Directive needs to be broadened to address these issues?

As mentioned above, we believe that specific abuses like "clandestine" or "creeping" position building, "empty voting" and questionable settlement practices should be more effectively addressed as part of the planned review of the Takeovers Directive and enhanced enforcement standards. Moreover, certain abusive practices should rather be addressed in light of the prohibition of market manipulation, as defined in the Market Abuse Directive.[3]

In addition, as certain countries have either already implemented or are in the process of implementation of various disclosure regimes for Equity Derivatives, it would be advisable to establish a pan-European regime which is as proportionate as possible. Having said that, since the vast number of participants in the Equity Derivatives markets do not seek to control or influence the issuer whose equity securities underlie the relevant instruments, it will probably not be necessary to broadly expand the Transparency Directive to create a comprehensive disclosure system.

As an example, one of the most recent reform initiatives has been taken by CONSOB, the Italian financial and securities regulator. In October 2009, it released a position paper inviting responses from market participants on several options relating to the possible extension of disclosure and mandatory takeover bid provisions to cash-settled Equity Derivatives. The main issues covered include, *inter alia*, (i) the adoption of a broad reporting regime, requiring disclosure of all the relevant positions held through cash-settled Equity Derivatives, irrespective of whether such instruments are cash- or physically-settled and exchange traded or negotiated over the counter, rather than a selective regime, based on a safe harbor approach, allowing non-disclosure of cash-settled Equity Derivatives that cannot be transformed by mutual amendment into physically-settled ones, (ii) an alternative between a nominal or a delta adjusted approach and (iii) the definition of efficient cases of exemption.

In addition to the above, it is worth noting that, on the one hand the Italian disclosure and takeover bid provisions currently in force do not cover cash-settled Equity Derivatives, whereas, on the other hand, the market abuse and internal dealing regulations require "relevant persons" (*e.g.*, directors, key managers, shareholders holding above 10% of the share capital) of Italian listed issuers to publicly disclose all purchase and sale transactions of physically-settled and cash-settled derivatives.

Q3. Do you agree that disclosure should be based on a broad definition of financial instruments of similar economic effect to holding shares and entitlements to acquire shares without giving direct access to voting rights?

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[2] Cf. Par. 4.

3 Directive 2003/6/EC, *cf.* Official Journal L 96/16, 12.04.2003.

We believe that the definition of financial instruments set forth by the Markets in Financial Instruments Directive[4] ("**MiFID**") is sufficiently comprehensive to cover all types of Equity Derivatives and therefore should be maintained. In addition, since both the Transparency Directive and the Prospectus Directive[5] make reference to the definition of financial instruments provided by MiFID, the adoption of a new definition exclusively relating to disclosure obligations might cause inconsistency within the European legal framework on securities and financial markets. Given that the use of coherent terminology as well as consistent definitions across the European Directives should be an important objective to achieve and considering CESR's aim to harmonize the approach among member states, we agree with CESR's view that the use of the MiFID definition would provide market participants with more legal certainty as to the instruments which fall within the scope of disclosure requirements in Europe.

Q4. With regard to the legal definition of the scope (paragraphs 50-52 above), what kind of issues you anticipate arising from either of the two options? Please give examples on transactions or agreements that should in your view be excluded from the first option and/or on instruments that in your view are not adequately caught by the MiFID definition of financial instrument.

We believe that the securities lending and "repo" businesses and corresponding stock lending and repurchase arrangements would become an intended addressee of proposed regulation since they inherently embed certain termination and equity recall rights.

For example, with respect to securities lending agreements and repurchase agreements, we note that these types of transactions fall within the disclosure obligations set forth by the Italian Financial Law (Legislative Decree n. 58 of February 24, 1998) and implementing regulations. According to such provisions, in case of repo transactions and security lending agreements, both the repo broker and the lender, on the one hand, and the repo payer and the borrower, on the other hand, are actually required to disclose such transactions. Under the Italian legal framework, both securities lending agreements and repo transactions are based on the assignment of ownership of the lent securities and the related voting rights to the repo payer or the borrower.

As to Germany, the BaFin has published the so-called "Issuer Guideline" (2nd edit. 2009) that summarizes how the voting right notifications provisions in the German Securities Trading Act (*Wertpapierhandelsgesetz*), implementing the requirements of the Transparency Directive, should be applied in connection with securities lending. In the most frequent scenario where the borrower is authorized to resell the borrowed securities, the BaFin has clarified that the lender must file a voting rights notification immediately upon the transfer of the securities to the borrower (even if the borrower has not yet resold and transferred the borrowed securities, voting rights will not be attributed to the lender any more).

CALCULATION OF THRESHOLDS

Q5. Do you think that the share equivalence should be calculated on a nominal or delta-adjusted basis?

We believe that at present time the share equivalence calculation would only be feasible on a nominal basis. While we understand the logic of the delta-adjusted approach, this calculation method would embed several significant challenges that may at this time be insurmountable. The calculations of any "delta" position disclosure employed by market participants likely contain elements of subjectivity, often rely on "net position" and "synthetic" hedging, raise proprietary concerns relating to disclosing hedging strategies and create excessive monitoring and calculation burdens. Admittedly, nominal reporting may essentially overstate the economic position relating to any derivative, but there is no guarantee that delta-adjusted positions, in light of the above-highlighted concerns, would not result in a greater degree of confusing reporting. Finally, certain market participants, for example corporate issuers, may not possess the technological capacity or know-how to properly evaluate their

[4] Directive 2004/39/EC; *cf.* Official Journal L 145 30.04.2004.
[5] Directive 2003/71/EC; *cf.* Official Journal L 345 31/12/2003

"delta-adjusted" positions for reporting purposes and would therefore be exposed to excessive and unnecessary expenditures relating to appropriate compliance.

Q6. How should the share equivalence be calculated in instruments where the exact number of reference shares is not determined?

In our opinion, the answers to these types of questions would be best addressed via consultation with market participants, particularly large financial institutions that fully appreciate the challenges related to reporting and well suited to determine whether accurate reporting is practically feasible. Notwithstanding the foregoing, we believe that any recommendations should include exemptions for structures where any "number" reporting would inherently be based on estimates or faulty methodology driven only by mere reporting requirements. Such measures would defy the principles behind the recommendations and complications embedded in them would be similar to those described in "delta-adjusted" reporting.

Q7. Should there be a general disclosure of these instruments when referenced to shares, or should disclosure be limited to instruments that contractually do not preclude the possibility of giving access to voting rights (the "safe harbor" approach)?

We believe that there is no principled reason that these types of instruments should not be subject to general disclosure (including appropriate exemptions) rather than implementation of the above-mentioned safe harbor. Legal assumptions underlying Equity Derivative transaction exemptions focus on the lack of any voting rights access by the counterparty, *i.e.*, absent specific or tacit agreement to the contrary, there are no voting rights attaching to the hedge position. Accordingly, a creation of a safe harbor based on a formalistic acknowledgment of such legal actuality would be self-serving and superfluous. In addition, implementation and policing of such safe harbor would, in our view, be very challenging.

SCOPE OF DISCLOSURE AND EXEMPTION CASES

Q8. Do you consider there is a need to apply existing TD exemptions to instruments of similar economic effect to holding shares and entitlements to acquire shares?

We strongly support the position that equivalent exemptions to those currently provided by the Transparency Directive, for example the market maker and trading book exemptions,[6] should apply to any reporting regime relating to Equity Derivatives. In addition, we believe that if the Transparency Directive exemption standards were to apply to Equity Derivatives, additional exemptions would become necessary. In general, client-servicing transactions should not trigger reporting obligations for the client-servicing financial institutions. Such obligations would already apply to the clients. Also, more specifically, in light of the issues raised in the Consultation Paper, sellers (writers) of cash-settled derivative positions should not fall under the purview of the Transparency Directive and transactions effected as *bona fide* hedging activities by financial institutions in the "ordinary course" of their Equity Derivatives businesses with respect to any similar transactions should also be subject to similar exemptions. Such exemptions are, in our view, appropriate to avoid duplicative and confusing disclosure. In addition, such exemptions are responsive to the conclusion that financial institutions have not been engaged in any "activist" transactions and in general employ policies that assure that the exercise of their voting rights with respect to any hedge positions cannot be effected in a way that would exert such influence.

Moreover, as the policy objectives behind the Consultation Paper focus on "activist influence" and "empty voting" it is appropriate to exempt corporate issuers from disclosure obligations with respect to *bona fide* transactions on their own securities and those of their affiliates. Finally, in our opinion, appropriate exemptions should be also available for the positions transferred

[6] Cf. Article 9, Par. 4 and 5, of Transparency Directive.

through intra-company or intra-group transactions, as long as the entity that ultimately controls the position has not changed, given that such transactions often occur for legitimate tax or accounting purposes.

Q9. Do you consider there is need for additional exemptions, such as those mentioned above or others?

As mentioned in our response to the preceding question, there is undoubtedly a need to consider and create additional exemptions to the ones currently provided by the Transparency Directive. An obvious additional exemption should cover any derivative positions maintained by financial institutions acting as underwriters and maintained as *bona fide* hedges to their underwriting positions and commitments. Those types of activities have been a significant element of underwriting activities and are necessary to efficient capital raising by corporate issuers. In addition, there is a need for practical exemptions covering positions held indirectly through collective investment schemes that combine multiple positions, such as baskets of securities, indices, investment funds, exchange-traded funds etc., unless appropriate thresholds could be identified where any relevant disclosure would be appropriate as a policy matter.

Finally, we would urge CESR to elaborate in its recommendations on the appropriate focus that should be given to the enforcement of current rules. A safe harbor regime merely focused on the contractual terms precluding buyers of "long" from exercising voting rights or focused on a lack of physical settlement may be appropriate, but it may be futile if it is not accompanied by a proper enforcement framework. As the Consultation Paper points out, any potential abuses relating to "settlement modification", "settlement coordination" or other "tacit" arrangements, can probably be only alleviated by vigorous enforcement. Otherwise, no matter how comprehensive or flexible the rules are, potential abusers will only find a way of creating a formalistic structure frustrating the letter and spirit of the rules.

Q10. Which kinds of costs and benefits do you associate with CESR's proposed approach?

In our opinion, the answers to these types of questions would be best addressed via consultation with market participants, particularly large financial institutions that fully appreciate the challenges related to potential reporting. Having said that, we believe that the costs relating to the implementation of the appropriate monitoring, compliance and reporting systems and technology may be substantial, or even prohibitive, to some market participants, particularly those market participants that are not major financial institutions. In addition, whereas we strongly believe that "market disclosure" is an appropriate way to address issues relating to pricing efficiency, the empirical data supporting expectations to potential benefits of the new comprehensive regime is rather dubious at this point, so any real benefits may be marginal and may not address the target issue – takeover protection.

Q11. How high do you expect these costs and benefits to be?

In our opinion, the answers to these types of questions would be best addressed through consultation with market participants, particularly large financial institutions.

Q12. If you have proposed any exemptions or have presented other options, kindly also provide an estimate of the associated costs and benefits.

In our opinion, the answers to these types of questions would be best addressed through consultation with market participants.

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We truly appreciate the opportunity to submit our comments to the Consultation Paper and hope that we can be helpful in the process of further evaluating any recommendations. In the meantime, if you have any questions or comments with respect to the foregoing, please feel free to contact any of the persons listed on the contact list attached to this letter.

We kindly ask you to treat this letter as strictly confidential. Therefore, this letter should not be published on the CESR website.

Yours respectfully

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