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MEMORANDUM

To / A **Committee of European Securities Regulators**

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Re / Réf. **Response to 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)**

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Gide Loyrette Nouel A.A.R.P.I. is a leading international law firm, founded in Paris in 1920, with 24 offices throughout Europe, Asia, Africa, the Middle East and North America and some 700 lawyers. The authors of this response are members of the Finance/Project Finance department and Alban Caillemer du Ferrage is head of the Derivatives / Derivatives Structured Finance team which practice is ranked by Chambers International as Top Tier one. The team regularly advises the Firm's institutional clients on regulations, structuring, drafting and collateralisation of complex OTC derivatives transactions and temporary transfers of securities, with a particular focus on strategy equity and structured credit deals.

We welcome the opportunity to respond to CESR's Consultation Paper ("**CP**") on its proposal to extend major shareholding notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares ("**Instruments of Similar Economic Effect**").

1. Extension of major shareholding notifications should not increase complexity or confusion

CESR's initiative to coordinate national efforts to harmonize existing regimes in the Member States for major shareholding notifications is welcomed, although deprived of any mandate from the European Commissions. Under the current Transparency Directive, which covers actual holdings of voting rights and assimilated (Articles 9 and 10) and financial instruments resulting in an entitlement to acquire existing shares with voting rights on the holder's own initiative alone (Article 13), it is possible for the Member States to choose whether or not aggregating the financial instruments captured by Article 13 to actual shareholdings for the purposes of calculating the thresholds. Such divergences of implementation of the Transparency Directive carried out by the Member States create confusions and increase monitoring costs for investors and asset managers operating throughout Europe.

In this context, CESR's intention to extend the scope of the Transparency Directive to Instruments of Similar Economic Effect should therefore aim at not leading to increase complexity or confusion to the existing diverging regimes in the Member States for major shareholding notifications by establishing specific and uniform rules with respect to Instruments of Similar Economic Effect.

2. Absolute transparency is not an objective itself

This initiative is, we understand, not only in response to some recent highly publicized cases where Instruments of Similar Economic Effects were used with the intention to influence or acquire control of a listed company, but also forms part of a general legislative and regulatory movement for greater transparency for privately negotiated derivatives transactions, including for example current regulatory initiatives on transparency for OTC credit derivatives.

Absolute transparency is however not an objective in itself and the purpose of the disclosure of major shareholdings is, as announced by the Transparency Directive (Recitals 18 and 20) and restated by the CP (§10), designed to enable investors to acquire or dispose of shares in full knowledge of changes in the voting structure and to clarify who actually exercises influence over an issuer.

Such purpose should be clearly kept in mind to avoid unnecessary, inexploitable or even misleading information being disclosed to the markets and, more importantly, to avoid discouraging innovation in financial markets or killing entire business lines and legitimate risk diversification tools by imposing irrelevant or excessive disclosure obligations.

3. Vast majority of such instruments are motivated by legitimate economic and operational reasons, not falling within the purposes of the Transparency Directive

We understand that the postulate on which is based the CESR's intention to broaden the scope of the Transparency Directive to capture all Instruments of Similar Economic Effect is that these instruments "*may potentially*" be used to acquire or exercise influence in a company (§1).

However such "potential" use of these instruments shall not be overestimated. Except very exceptional cases, the overwhelming majority of the equity derivatives are not motivated by such intention and as noted by the CP, such instruments "*are generally entered into to give economic exposure without wishing to gain access to voting rights and are an important source of liquidity to the market*".

There are an unlimited number of perfectly legitimate economic and legal reasons for entering into such financial instruments without physical delivery of underlying shares, such as tax considerations, avoiding operating risks and costs related to delivery of shares, gaining financial leverage for exposure to the price performance of a stock, risk diversification for a portfolio manager or monetization by a shareholder of part of its holding in a listed company.

These instruments, generally speaking, are therefore not falling within the purposes of the Transparency Directive of enabling investors to acquire or dispose of shares in full knowledge of changes in the voting structure and clarifying who actually exercises influence over an issuer.

Such instruments could also be "written" or entered into for a size of underlying equities that is several times a multiple of the actual share capital of their issuer, without creating any corner or liquidity issue because of their cash settlement.

Regulators would be well advised that general disclosure requirements on these instruments by treating them as actual shareholding for notifications purposes would lead to misleading information diluting meaningful and significant disclosure on the actual major shareholdings and voting rights structure and, worse, discouraging use of instruments whose essence lies in the confidentiality and decreasing liquidity of the market.

4. A balance needs to be found to reach a proportionate transparency

It is hence worth considering whether a general disclosure regime assimilating purely cash-settled instruments to actual shareholdings is necessary.

In this respect, we would like to make two remarks to Section V of the CP which outlines national initiatives:

- The United Kingdom is currently the sole Member State which has introduced general disclosure obligations for exclusively cash-settled derivatives instruments with similar economic effect, which are required to be aggregated with actual holdings in shares for the purposes of notifications. It does not seem, by far, that this has been followed by any consensus within Europe. It is even often believed that such an undesirable regime should at all costs be avoided as a standard or a landmark.

  We remind that those rules are of a corporate law nature rather than a stock exchange regulations. It means that they apply to issuers incorporated in the relevant regulating Member State, and not the Member State of the stock exchanged where their shares are admitted on. In very practical term, this means that the UK regime, given the relatively small size of the overall UK issuers' capitalization in comparison to other European countries, and despite the size of the City's stock exchange, has so far had a marginal impact on the global business. It is therefore essential to ensure that French, German and Italian, as biggest markets, have a determinant say on those issues.

- In France precisely, the new regime[1] for major holding notifications is well balanced between the need for transparency and the need to preserve liquidity and legitimate trading. It does not require cash settled instruments to be aggregated to actual holdings in shares for calculating whether the thresholds are reached. However, those instruments become reportable, and shall be disclosed in a separate notification, when the actual holdings in shares and entitlement to acquire shares triggers notification obligation. A distinction has thus been made by French regulators between instruments covered by Article 13 of the Transparency Directive (financial instruments resulting in an entitlement to acquire, on the holder's own initiative alone, existing shares with voting rights) which enable the holder of the instruments to actually exercise influence, and purely cash-settled instruments which do not.

The balance, in our opinion, can therefore been found by (i) creating a uniformed pan-European regime specific to cash-settled instruments creating long economic exposure without aggregation to actual holdings and instruments already covered by Articles 9, 10 and 13 the Transparency Directive, (ii) requiring reporting of only substantial and significant long positions (higher than 5%) created by such instruments and (iii) maintaining exemptions for investment services firms.

[1] Ordinance No. 2009-105 of 30 January, 2009.

REPORTING INSTRUMENTS OF SIMILAR ECONOMIC EFFECT TO HOLDING SHARES AND ENTITLEMENTS TO ACQUIRE SHARES

Question 1. 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?

We do not entirely agree with CESR's analysis which, in our view, gives a partial assessment of the use of these instruments and lies on an intellectual misconception of their general use and purposes.

The use of those instruments with the intention to acquire or exercise influence in a listed company or allow for creeping control should as we say neither be overestimated nor systematically presented as their real hidden goal.

Issues quoted by CESR are the following: *de facto* control over the voting rights, delivery of underlying shares in practice and information asymmetry.

1. ***De facto* control**

It is a judgment on mere intent to state that the writer of such instrument "*will naturally wish to obtain repeat business from the holder*" who exercises thus a degree of *de facto* control over the voting rights attaching to the shares held as hedge, there is in reality no evidence that hedging banks vote under the influence of their clients.

On the contrary, according to the Survey on Contracts for Difference carried out by PricewaterhouseCoopers LLP for the FSA, all respondents "*categorically stated that they would not vote under the instruments of any client but reserve the right for themselves to vote instances where it is in their interest as a bank or a group*".

Furthermore, hedging banks can benefit from the trading book exemption (when the shares held as hedge represent less than 5% of the share capital of the listed company) only if they ensure that the voting rights attaching to shares are not exercised nor otherwise used to intervene in the management of the issuer (Article 9(6) of the Transparency Directive).

In addition, in the event that such influence that the holder of such instruments may exercise over the voting rights attached to the underlying shares through its counterparty could be characterised as the counterparty holding such voting rights "*on behalf of*" the holder, such situation is captured by Article 10(g) of the Transparency Directive requiring aggregation of such voting rights held "*on behalf of*" the holder.

2. **Instruments facilitating delivery of underlying shares**

Instruments of Similar Economic Effect, purely cash-settled equity derivatives, do not, in essence, involve any delivery of underlying shares by hedging banks to the holders. If such cash-settled instruments structured in such a way that they facilitate, in practice, the purchase by their holder of the underlying shares from the hedging banks, they could be (i) either within the definition of instruments giving entitlement to acquire shares pursuant to Article 13 (provided on the holder's own initiative only) or (ii) captured by the concept of "action in concert" (Article 10(a)) through which shares held as hedge by hedging banks are to be aggregated to actual shareholding for the purposes of notifications, if they have an agreement, express or implied, to adopt a lasting common policy towards the management of the issuer in question.

Also if the intention of a few parties was to hide what initially had been agreed to be a cash settlement, this is an obvious fraud, for which they should solely be condemned, but not the entire market.

3. Information asymmetry

It is true that, even in the absence of any express or implied agreement with respect to the delivery of underlying shares, the holder of such instruments is the sole to know the shares held as hedge and when they will be available in the market (i.e. when the contract is terminated).

Such information advantage that the holder of Instruments of Similar Economic Effect may have over the rest of the market, as well as the information asymmetry regarding the free float of the share capital of an issuer as mentioned in (ii) of the paragraph 17 of the CP, may to an exceptional extent create disruption to the market (cf. Case Porsche/VW).

A proportionate fix to such information asymmetry is, in our view, in line with the French regime, to impose the giving to the market of all relevant information on these instruments if and when they, without aggregation to the actual holdings, procure a substantial long economic position and involve constitution of a significant delta.

Question 2. Do you agree that the scope of the Transparency Directive needs to be broadened to address these issues?

We do not agree with CESR's statement (§ 38) that "*the scope of major shareholding disclosure should include all instruments that give similar economic effect to holding shares or entitlement to acquire shares, irrespective of whether such an instrument is settled in cash or physically*" for the reasons explained in the introductory paragraphs of this response.

We do not see any reason why the CP links information on free float in the market to the purpose of major shareholding disclosure to clarify who actually can exercise influence over an issuer (§39). Those are two totally different topics.

We do not see why including Instruments of Similar Economic Effect is a "logical next step" (§40) after including entitlements to acquire given the fact United Kingdom is the sole Member State which has introduced a full disclosure regime treating Instruments of Similar Economic Effect as actual shareholdings for notifications purposes. There is no consensus on the opportunity of such alignment.

CESR's statement that the current thresholds set under the Transparency Directive should apply to Instruments of Similar Economic Effect because "*it is likely that an investor with a significant economic long interest will seek to influence the issuer*" is without any evidence to support (cf. paragraph 3 of the introduction hereof and our response to Question 1). Such influence is in most cases hypothetical.

However, we agree that, given the information asymmetry that private negotiated cash-settled instruments may create (cf. our answer to Question 1) whereas the purposes announced by the Transparency Directive is to "*enable investors to acquire or dispose of shares in full knowledge of changes in the voting structure*", investors and the market should be given access to a proportionate information on the Instruments of Similar Economic Effect representing a substantial long economic position and as a result, involving constitution of an important delta by hedging banks.

To this end, the scope of the Transparency Directive needs to be broadened but only to create a specific disclosure requirement to Instruments of Similar Economic Effect giving a substantial long economic position, with specific thresholds and contents to be disclosed, on a separate basis, without being aggregated to actual shareholdings or entitlements covered by Articles 9, 10 and 13 of the Transparency Directive.

BROAD DEFINITION

Question 3. Do you agree that disclosure should be based on a broad definition of instruments of similar economic effect to holding shares and entitlements to acquire shares without giving direct access to voting rights?

We agree that should a specific disclosure regime be established for such instruments, a broad definition could be adopted, with the limit that such instruments shall reference to shares already issued.

Question 4. 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.

The second option by reference to the definition of financial instruments in MIFID is preferable in our opinion, as it allows more legal certainty for investors and practitioners and ensures a certain consistency between the two directives.

We do not understand why the CP mentions "private contracts" when wondering whether they are adequately caught by the definition of financial instruments. OTC derivatives contracts are by nature "private".

As to repurchase agreements or right to recall lent securities, we believe that they are caught by Article 10(b) of the Transparency Directive pursuant to an agreement "*providing for the temporary transfer for consideration of the voting rights*".

CALCULATION OF THRESHOLDS

Question 5. Do you think that the share equivalence should be calculated on a nominal or delta-adjusted basis?

If the purpose of the notification is to inform the market of those investors who may potentially exercise an influence on the issuer through cash settled equity derivatives, the degree of such "influence", assuming it exists, may only be measured by the actual delta held by hedging banks.

Moreover, to correct the information advantage a holder of such instruments may have over the market, only information over the delta rather than the nominal can actually achieve this goal.

However, delta-adjusted approach will potentially result in the thresholds being crossed up and down constantly and lead to holders' modifying its notification on a daily basis, overloading thus the market with useless information.

More importantly, such notification by the holders of such instruments supposes that hedging banks inform the holders, on a daily basis, the adjustments of the delta made by them. This not only in practice is difficult to implement, but also legally could interfere with hedging banks independence to carry out their hedging activities.

We consider therefore that the share equivalence should be calculated on a nominal basis without netting between long and short positions.

Question 6. How should the share equivalence be calculated in instruments where the exact number of reference shares is not determined?

This question deserves more clarification and consideration. We could however try to work on a share equivalence by reference to similar instruments listed on the exchange referencing the same underlying stocks.

SCOPE OF DISCLOSURE

Question 7. 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 harbour” approach)?

We agree with CESR's conclusion that the "safe harbour" approach is unworkable.

Should the general assumption made by CESR be accepted that purely cash-settled derivatives instruments not providing for delivery of shares or exercising voting rights are likely to be used to influence the company or acquire control, contractual terms to preclude such possibility, by definition, do not fix such problem as the sanction for any breach of such undertakings can only be of contractual nature between parties to the agreements.

Question 8. 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?

Yes, the existing exemptions should be extended to Instruments of Similar Economic Effect.

The application of the exemption of the trading book to Instruments of Similar Economic Effect shall mean, on one hand, that (1) such Instruments of Similar Economic Effect should not be aggregated to actual shareholdings for calculating the thresholds of trading book and, on the other hand, that (2) they should be reportable, on a separate basis, only if and when they represent a substantial long position crossing up a relatively high threshold.

Question 9. Do you consider there is a need for additional exemptions, such as those mentioned above or others?

We have not yet identified any need for additional exemptions.

COSTS AND BENEFITS

Question 10. Which kinds of costs and benefits do you associate with CESR’s proposed approach?

The expected benefit of CESR's proposal to enhance transparency needs to be balanced against the potential immense infrastructure and monitoring costs. This shall be particularly taken into consideration in the context where the Transparency Directive level 1 and level 2 has been implemented throughout Europe very recently requiring substantial system adjustments by not only investment services providers and investors but also issuers and supervisors.

We anticipate that costs will be substantial compared to very limited benefits for the market participants:

(i) notification triggered by aggregation of actual shareholdings and Instruments of Similar Economic Effect would lead to useless and misleading information as to the actual voting structure of the issuer and the actual power or influence a shareholder may have over the issuer, being noted that vast majority of Instruments of Similar Economic Effect only procure an exposure to the price performance of the underlying shares without giving access to voting rights;

(ii) full disclosure would also give rise to double counting which is more of a lack of transparency rather than transparency;

(iii) in many circumstances, the hedge positions may be managed on a daily basis or in a dynamic way, which means referenced shares would be lent to third parties or otherwise disposed of before the close-out of the instruments and without the holder's knowledge. We are not sure that in such circumstances, the market needs to be informed of the economic interest of long parties.

We agree however that a pan-European approach will reduce the associated costs compared to diverging national approaches.

Question 11. How high do you expect these costs and benefits to be?

See our response to Question 10.

Question 12. If you have proposed any exemptions or have presented other options, kindly also provide an estimate of the associated costs and benefits.

We believe that a fully harmonized pan-European disclosure regime to Instruments of Similar Economic Effect, treated separately from the diverging existing major shareholding notifications, will help to reduce system development costs, on a European level, for investors and asset managers operating throughout Europe.

This approach will be able to help the market to dissociate actual shareholding and entitlements to acquire giving access to voting rights from those instruments which are only likely, in exceptional cases, to be used to exercise influence and thereby protect the market from excessive transparency which dilutes meaningful information and in the meantime provide the market with information on instruments creating significant long economic position.

The extension of the existing exemption of the trading book to Instruments of Similar Economic Effect as we suggested in the response to Question 8 (i.e. non aggregation of such instruments to actual holding for calculating whether the threshold of the trading book is reached and separate threshold and separate notifications for these instruments) will also contribute to maintain a proportionate transparency and encourage development and use of innovative financial instruments for legitimate economic reasons (cf. our development in § 3 of the introduction hereof).

Obviously, this approach limiting the frequency of notifications will involve less infrastructure and monitoring costs.

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