Securities and Markets Stakeholder Group

Date: 26 May 2014
ESMA/2014/SMSG/030

Advice to ESMA

Response to ESMA's Consultation Paper on Draft Regulatory Technical Standards on major shareholdings and indicative list of financial instruments subject to notification requirements under the revised Transparency Directive

I. Executive Summary

The objective of this paper is to provide advice to ESMA on the Consultation Paper on Draft Regulatory Technical Standards on major shareholdings and indicative list of financial instruments subject to notification requirements under the revised Transparency Directive.

The SMSG very much welcomes ESMA's balanced approach between strengthening disclosure of major shareholdings and avoidance of unnecessary costs for market participants.

The key messages the SMSG would like to highlight towards ESMA for consideration in its work going forward regarding finalizing regulatory technical standards and establishing an indicative list of financial instruments subject to disclosure are:

- ESMA's proposals for dealing with the exemptions from disclosure obligations provided for trading book and market maker holdings is convincing. In particular, the SMSG strongly supports ESMA's proposal introducing a rule on the aggregation of holdings in a group of companies. The SMSG also agrees with ESMA's approach exempting a parent undertaking from notification requirements provided that its subsidiaries can be considered as independent. But it will be important that national competent authorities evaluate whether the principles of independence are fulfilled in a consistent way. The SMSG therefore urges ESMA to ensure a consistent application of the exemption in the future.

- The revised Transparency Directive will lead to more disclosure of financial instruments. The SMSG agrees with ESMA's observation that there will be a risk of a high number of irrelevant notifications. This might explain ESMA's mandate to specify certain cases in which exemptions laid down in the Transparency Directive apply to financial instruments held by a natural person or legal entity fulfilling orders received from clients. However, the level 1 text is ambigious. The SMSG is of the opinion that the Transparency Directive does not mandate ESMA to establish a separate exemption for client serving transactions. The problem of potentially excessive and irrelevant disclosure of financial instruments has to be solved on level 1 by the Commission, European Parliament and Council.

- The revised Transparency Directive requires ESMA to establish an indicative list of financial instruments that are subject to notification requirements. Although the list will not be legally binding the SMSG believes that it will be a valuable support for investors in assessing whether financial instruments have to be disclosed or not. The SMSG observes that ESMA has examined in depth whether financial instruments should be made public under the Transparency Directive. In addition, it would be beneficial for the market to learn if financial instruments are not subject to notifi-

cation requirements. The SMSG understands that the Transparency Directive does not request ESMA to establish a white list. But it would be helpful if ESMA explained its considerations for including certain instruments in the list and on this occasion explains whether comparable instruments are not covered by the Transparency Directive.

II. Background

1. On 22 October 2013, the European Parliament and the Council adopted Directive 2013/50/EU amending Directive 2004/109/EC on the harmonization of transparency requirements (Transparency Directive – "TD"). One of the main aims of the revised TD is to ensure that issuers and investors have full knowledge of the structure of corporate ownership. Therefore, the revised TD provides a new definition of financial instruments which are subject to disclosure.

2. The revised TD mandates ESMA with the elaboration of draft regulatory technical standards (draft RTS) to specify the conditions for the application of existing exemptions from notification requirements for major holdings of voting rights. In particular, ESMA shall determine cases of exemptions while taking into account their possible misuses to circumvent disclosure obligations.

3. To collect input on some regulatory issues, ESMA organized an informal round table on 26 September 2013 with representatives of market participants, including issuers, investment management funds and associations, banks, other investment service providers and corporate finance advisors.

4. On 21 March 2014, ESMA published its Consultation Paper on "Draft Regulatory Technical Standards on major shareholdings and indicative list of financial instruments subject to notification requirements under the revised Transparency Directive" ("CP"). A few days later, ESMA asked the Securities Markets Stakeholder Group ("SMSG") to respond to the CP.

III. Comments

5. The SMSG very much welcomes ESMA's excellent CP. ESMA follows a balanced approach between strengthening disclosure of major shareholdings and avoidance of unnecessary costs for market participants. Furthermore, the SMSG recognizes that the CP explains the backgrounds of the proposed RTS in depth and can very well imagine that it will be a reference for future interpretation of the level 2-regime.

6. The SMSG responds to most of the topics ESMA's CP is dealing with. Its comments focus on fundamental regulatory issues. Additionally, the SMSG addresses several technical points which should be considered by ESMA when submitting the draft RTS to the Commission for endorsement.

Trading Book and Market Maker Exemption

Question 1: Do you agree that the trading book and the market maker holdings should be subject to the same regulatory treatment regarding Article 9(6b) RTS?

7. According to the revised TD, the notification requirements laid down in the TD are not applicable to voting rights held in the trading book, provided that these rights do not exceed 5 % and are not exercised or otherwise used to intervene in the management of the issuer (cf. Article 9 (5) TD). A further exemption exists for the acquisition or disposal of a major shareholding reaching or crossing the 5 % threshold by a market maker, provided that it is authorised by its home Member State and it neither

intervenes in the management of the issuer concerned nor exerts any influence on the issuer to buy such shares or back the share price (cf. Art. 9 (6) TD).

8. There are some differences between the two exemptions. ESMA however is right to point out that this does not preclude following a common approach for specifying the method of calculation of the 5 % threshold referred to in the two exemptions, since both exemptions are supported by the same regulatory purpose. Firstly, the two exemptions take into account that the disclosure regime intends to clarify who might be interested in exercising influence over an issuer. Secondly, notification requirements can entail unnecessary burdens for a market maker and a credit institution holding voting rights solely with trading intent. Thus, the SMSG agrees that the trading book and the market maker holdings should be subject to the same regulatory treatment regarding Art. 9 (6b) TD.

Question 3: Do you agree with the ESMA proposal of aggregating voting rights held directly or indirectly under Articles 9 and 10 with the number of voting rights relating to financial instruments held under Article 13 for the purposes of calculation of the threshold referred to in Article 9(5) and (6)? If not, please state your reasons.

9. The revised TD takes into account that financial innovation has led to the creation of new types of financial instruments which were used to secretly acquire shares in companies. Therefore, it firstly makes sure that instruments with a similar economic effect to holding shares and entitlements to acquire shares have to be disclosed to the market. Secondly, the revised TD requires the aggregation of the holding of shares with holdings of financial instruments. This approach is taken in order to ensure transparency and investor protection (cf. Recital 8 revised TD).

10. In view of the above the SMSG strongly supports ESMA's proposal of aggregating voting rights attached to shares (Article 9 and 10 TD) with voting rights relating to financial instruments (Article 13 TD) for the purposes of calculation of the threshold referred to in the exemptions for market makers and trading books. The SMSG is aware of the fact that ESMA's proposal might lead to more notifications by credit institutions and thus to greater costs for them. However, as stated by the CP, the proposed RTS are in line with the regulatory aim of the revised TD. In addition, not doing so might create a potential loophole as it seems strange that banks would build large derivative positions for the purpose of market making. As to the trading book, large derivative positions might make more sense, but there is an argument for simplification and therefore treating both exemptions in the same way. Finally, the suggested approach is already applied in some Member States who had extended the disclosure regime prior to the revision of the TD, such as Germany (cf. BaFin, Issuer Guideline, 2013, page 132 for the trading book exemption), although others such as France (cf. Art. L. 233-9-II, 3 Commercial Code) have not done so primarily in order to provide more flexibility and reduce costs for their banking sectors.

Question 5: Do you agree that, in the case of a group of companies, notification of market making and trading book holdings should be made at group level, with all holdings of that group being aggregated (Article 3(1))?

11. The TD did not initially provide any rules with regard to a group of companies in the context of the two exemptions. Thus, holdings of a market maker are currently not attributed to the parent undertaking for the purposes of calculation of the threshold provided for in Article 9 (5) and (6) TD. However, according to the revised TD, this will change in the future. ESMA shall draft RTS to specify the method of calculation of the 5 % threshold, including the case of a group of companies.

12. The SMSG strongly supports ESMA's proposal introducing a rule on the aggregation of holdings in a group of companies. It takes into account that a parent undertaking has control over its subsidiaries and may influence its management. Again, ESMA's proposal might lead to more notifications by credit institutions and thus to greater costs for them. But ESMA also suggests to exempt a parent undertaking from notification requirements if the subsidiary can be considered as independent (see para. 15-17 of this Advice). Thus, ESMA's proposal principally tackles the problem of a possible increase in costs.

13. Although ESMA's approach is generally convincing, the SMSG raises two technical questions which ESMA should deal with. The first one refers to the wording of Art. 3 (1) draft RTS. According to ESMA's proposal, holdings shall be aggregated at "group level". This term is defined in Directive 2013/34/EU as follows: "'group' means a parent undertaking and all its subsidiary undertakings." Thus, Art. 3 (1) draft RTS could be interpreted in the way that holdings are not only attributed to the parent undertaking but also to subsidiaries in a multilevel group, which can surely not be ESMA's intention. The SMSG therefore requests ESMA to clarify that holdings are solely attributed to the parent undertaking.

14. A second question is how cases are dealt with in which a parent undertaking is not considered a credit institution and therefore does not profit from the exemptions provided for market makers and trading books. For example, subsidiary A and subsidiary B in a multilevel group each hold a stake of 3 % in their trading books. ESMA does not deal with this situation in its CP but it is a practically relevant scenario which should be tackled in line with the level 1-regime. The SMSG understands that A and B would be exempt from disclosure requirements according to Art 9 (6) TD. However, are A and B's holdings attributed to the parent undertaking which is not a credit institution or an investment firm and therefore do not have a trading book? The SMSG is of the opinion that Art. 9 (6) TD does not apply to such a parent undertaking and therefore Art. 3 draft RTS neither. The legal basis for the aggregation of A and B's holdings to the parent undertaking can only be Article 10 (e) TD which should not be derogated by Art. 3 draft RTS. Thus, the holdings of each subsidiary would have to be aggregated to the parent undertaking, provided that the prerequisites laid down in Article 10 (e) TD are fulfilled.

Question 6: Do you agree that an exemption to notify at group level can apply if an entity meets the independence criteria set out under paragraph 72(Option 2)?

15. The SMSG strongly supports ESMA's approach exempting a parent undertaking from notification requirements provided that its subsidiaries can be considered as independent. The competence of ESMA to provide an exemption follows from the reference to Article 9 (6b) that TD is making ("taking into account Article 12 (4) and (5)"). The SMSG understands that the proposed rule is limited to the two exemptions for market makers and trading books. Thus, it neither applies to the general rule on the attribution of voting rights in a group of companies (Article 10 (e) TD) nor should it be applied analogously.

16. The SMSG believes that the proposed independence test is convincing. Specifically, the SMSG agrees that the parent undertaking of a credit institution or investment firm, wishing to benefit from the exemption in relation to holdings under Article 9 (5) and (6), should ensure that the credit institution or investment firm exercises voting rights unrelated to the shares held in connection with the trading book and market making activities independently. However, this criterion, also adopted in Article 3 (6) (b) draft RTS in the context of establishing compliance structures, should be put into more concrete terms.

17. In any case, it will be important that NCAs evaluate whether the principles of independence are fulfilled in a consistent way. The SMSG therefore urges ESMA to ensure a consistent application of the exemption in the future.

Method of calculation the number of voting rights in case of financial instruments referenced to a basket of shares or an index

Question 9: Do you agree with the proposal that financial instruments referenced to a basket or index will be subject to notification requirements laid down in Article 13(1a)(a) when the relevant securities represent 1 % or more of voting rights in the underlying issuer or 20 % or more of the value of the securities in the basket/index or both of the above?

18. ESMA's proposal reflects the regulation which is already in place in some Member States. It is identical with the law in the UK [DTR 5.3.3 FCA Handbook – Guidance] and similar to the one in Germany [§ 17 No. 2 WpAIV – rule]. Thus, market participants are already familiar with the prerequisites ESMA is suggesting. The SMSG supports that ESMA adopts provisions already satisfactorily developed and applied in the Member States.

Question 10: Are there any other thresholds we should consider?

19. The SMSG observes that UK law provides a further rule requiring transparency if the "use of the financial instrument is connected to the avoidance of notification." It is hardly conceivable that an investor might secretly build an influential position by acquiring financial instruments referenced to a basket or index which are not subject to notification requirements. Furthermore, the rule in the UK is too vague and not specific enough. Thus, the SMSG is of the opinion that such a provision or other thresholds should not be implemented by ESMA.

Method of determining delta for the purposes of calculation of voting rights relating to financial instruments which provide exclusively for a cash settlement

Question 13: Do you agree that our proposal for the method of determining delta will prevent circumvention of notification rules and excessive disclosure of positions? If not, please explain.

20. The notification requirements of the TD also apply to a person who holds certain financial instruments, such as cash settled derivatives. The number of voting rights shall be calculated by reference to the full notional amount of shares underlying the financial instrument except where the financial instrument provides exclusively for a cash settlement, in which case the number of voting rights shall be calculated on a delta-adjusted basis by multiplying the notional amount of underlying shares by the delta of the instrument. ESMA shall develop draft RTS to specify the methods for determining delta for the purposes of calculating the voting rights relating to financial instruments which provide exclusively for a cash settlement.

21. The existing national laws do not provide any rules on this question. The reason for this is that most of the Member States require calculation of the number of voting rights on a fixed basis of 1. The

UK, requiring the calculation on a delta-adjusted basis, does not regulate the details. The FCA Handbook only gives guidance to the market by stating that holders of long derivative financial instruments not having a linear, symmetric pay-off profile in line with the underlying shares should monitor delta changes at the end of each trading day in order to determine whether a disclosure is required.

22. Against this background, ESMA had to develop a regime which, on the one hand, does not represent an excessive administrative burden for market participants, and, on the other hand, ensures full transparency of economic ownership of publicly listed companies. The SMSG considers that ESMA has reached this goal.

23. The SMSG acknowledges that a prescriptive approach demanding the calculation of voting rights according to one or more precise delta-adjusted methods is not preferable. It is not possible to require a specific formula which is appropriate for all potential financial instruments. ESMA is therefore right in following a principle based approach. On the one hand, ESMA's draft RTS are flexible since investors may apply general accepted standard pricing models. On the other hand, investors have to take into account that a pricing model has to consider certain elements that are relevant to the valuation of the financial instrument such as interest rate, dividend payments, time to maturity, volatility and price of the underlying share.

24. Art. 5 draft RTS on determining delta is well designed. However, the SMSG raises one technical question which ESMA should deal with before submitting the draft RTS to the Commission for endorsement. According to Article 5 (6)2 draft RTS "the holder shall notify the issuer when he reaches, exceeds or falls below the thresholds provided for in Article 9(1)". The SMSG observes that with this rule ESMA intends to clarify that disclosure can be required due to changes of delta. However, the provision could be misunderstood. Article 5 (6)2 draft RTS could be interpreted as special law requiring a notification if an investor reaches, exceeds or falls below the thresholds "provided for in Article 9(1)", namely 5, 10 % etc. In fact, the disclosure obligation already follows from national law. Member States have transposed Art. 9 (1) and 13 (1a) TD, mostly by providing additional thresholds. This will be the legal basis for disclosure obligations. The SMSG recommends to remove Article 5 (6)2 draft RTS and to indicate in the recitals that a disclosure obligation might arise, depending on the national law.

Client-serving transactions

Question 15: Are these three types of client serving exemptions all appropriate in terms of avoiding excessive or meaningless disclosures to the market? Please provide quantitative evidence on the additional costs borne by financial intermediaries should any of these exemptions not be adopted.

25. ESMA is requested to "develop draft RTS to specify the cases in which the exemptions [laid down in Article 9 (4), (5) and (6) and in Article 12 (3), (4) and (5)] apply to financial instruments held by a natural person or legal entity fulfilling orders received from clients or responding to a client's request to trade otherwise than on a proprietary basis, or hedging positions arising out of such dealings". This mandate to ESMA can be explained by the extension of the duty to disclose financial instruments, such as cash settled equity swaps. In the above mentioned cases of client-serving transactions there is a risk of a high number of irrelevant notifications. In all types of transactions the long

position held by the client-serving entity does not primarily serve its own interest and normally will not be used to exert influence on the issuer.

26. ESMA is not sure how its mandate in the level 1-text is to be understood and presents two possible interpretations and thus different possible RTS. Option 1 interprets the mandate in a literal way. Thus, ESMA would have to decide whether the trading book, market maker and the other exemptions apply to the three types of client-serving transactions. Option 2 is based on a teleological interpretation of the mandate. As a consequence, ESMA would have to decide whether and under which conditions the three types of client-serving transactions should be exempt from disclosure obligations.

27. The SMSG observes that Option 2 would be in line with the purpose of the TD and most appropriate to avoid meaningless notifications. However, adopting Option 2 would mean that ESMA would establish a further exemption from the notification requirements. The TD does not mandate ESMA in this regard. The SMSG is of the opinion that ESMA should restrict itself to the mandate given in the level 1-text. The problem has to be solved on level 1 by the Commission, European Parliament and Council.

Indicative list of financial instruments

Q21: When does a financial instrument have an "economic effect similar" to that of shares or entitlements to acquire shares? Do you agree with ESMA's description of possible cases?

28. The TD differentiates between two categories of financial instruments subject to notification requirements: (i) instruments which give the holder the right to acquire shares or the discretion as to this right to acquire shares (Art. 13 (1) (a) TD); (ii) instruments which are referenced to shares with similar economic effect. Some instruments are listed in the level 1 text, such as transferable securities, options, futures, swaps, forward rate agreements, contracts for difference and any other contracts or agreements with similar economic effects which may be settled physically or in cash (Art. 13 (1) (b) TD). In addition, ESMA shall establish and periodically update an indicative list of financial instruments that are subject to notification requirements, taking into account technical developments on financial markets (cf. Article 13 (1b) TD).

29. ESMA's indicative list will not be legally binding. It will rather be an instrument of soft law which gives guidance to the market. The SMSG believes that the list will be a valuable support for investors in assessing whether financial instruments have to be disclosed or not. NCA's should either refer to ESMA's list on their websites or adopt it into their guidance.

30. The SMSG observes that ESMA has examined in depth whether financial instruments should be made public under the TD. It welcomes ESMA's efforts to provide a valuable guidance for market participants, not only by listing financial instruments subject to disclosure but also by explaining the reasons for doing so. This is especially important since there are different understandings in the Member States about the characteristics of equity-like financial instruments, such as warrants and stock options. Most of the explanations are clear and comprehensive. But ESMA could clarify that all of the conditions mentioned under para. 159 CP need to be fulfilled.

31. The SMSG recognizes ESMA's strong commitment to ensure a high level of transparency. However, it is questionable whether any shareholders' agreements having financial instruments as its subject, should itself be considered a financial instrument (cf. para. 199 CP). For example, it is hardly conceivable that pre-emption rights are used to secretly acquire shares in a company. The SMSG believes that the disclosure of such agreements is not necessary in order to ensure that issuers and investors have full knowledge of the structure of corporate ownership.

32. The SMSG is of the opinion that it would be beneficial for the market to learn if financial instruments *are not* subject to notification requirements. The SMSG understands that the TD does not request ESMA to establish a white list ensuring legal certainty for investors and issuers. But it would be helpful if ESMA explained its considerations for including certain instruments in the list and on this occasion explains whether comparable instruments are not covered by the TD. Market participants might draw valuable conclusions from the explanations. ESMA has already proceeded in this way in the CP, especially with regard to convertible and exchangeable bonds (cf. para. 182-184) and contractual buying pre-emption rights (which shall not fall under Article 13 (1)(a) TD, but should be considered as economically equivalent to holding shares, within the meaning of Article 13 (1) (b) TD). The SMSG encourages ESMA to use the same approach when establishing the indicative list.

Question 22: Do you think that any other financial instrument should be added to the list? Please provide the reasoning behind your position.

33. ESMA has dealt with all relevant financial instruments which might be subject to notification requirements. However, there may be further instruments falling under Art. 13 TD. This can only be evaluated by taking into account the special characteristics and features of national civil and company law. A possible example would be the pledging of shares.