



Equity Derivatives – Public Consultation Response Statement Dated 11 May 2008

INTRODUCTION

On 10 September 2007, the Takeovers Panel released a draft Guidance Note on equity derivatives (GN) and an accompanying Discussion Paper for public comment. Comments on the draft GN and the Discussion Paper were due by 7 December 2007.

The Panel received six submissions in response to the GN. The Panel thanks those who made submissions for their comprehensive comments. Consistent with the Panel's published policy on responding to submissions, this paper sets out the Panel's response to the public consultation process and its conclusions on the main comments received from respondents.

MATERIAL COMMENTS RECEIVED AND PANEL'S CONCLUSIONS

Equity derivatives are legitimate instruments

Comment

The overview to the draft GN noted that equity derivatives are legitimate instruments and that the great majority of equity derivatives do not concern the Panel. Two respondents suggested however that the tone of the draft GN assumed that derivatives were largely used for avoidance. Another respondent stated that the draft GN implied that equity derivatives were not typically traded for investment and risk management purposes and were used for the accumulation of a position to facilitate a takeover action.

Response

The Panel has given additional emphasis to the legitimate role of equity derivatives as trading and risk management products in paragraph 4 of the GN

Providing additional disclosure of equity derivatives

Comment

Two respondents submitted that essentially there was no need for additional disclosure of equity derivatives. One of them argued that there was no basis for additional disclosure because equity derivatives were entered for the purpose of making an economic profit, rather than controlling or influencing the entity. One submission suggested that protocols that dealt with "the unwind" of cash settled swaps would be preferable to disclosure.

Response

The Panel considered these submissions but remained concerned that the non disclosure of long positions¹ of over 5% may be unacceptable, particularly in a control situation. Paragraph 9 of the GN stated that where “there is a control transaction, the Panel would expect that all long positions which already exist, or which are created, are disclosed unless they are under a notional 5%”.

The way the GN should be written*Comment*

One respondent submitted that the draft GN read more like a rule than guidance.

Response

The GN has been rewritten to make it clear that it provides guidance to the market about issues the Panel will consider when deciding whether circumstances involving the non disclosure of long positions are unacceptable.

Should the GN be limited to control situations?*Comment*

Five respondents submitted that the Panel’s guidance on disclosure of equity derivatives should be limited to control situations only.

One respondent submitted that the Panel’s powers were limited to control situations. The respondent was concerned that if a Panel was to make a declaration of unacceptable circumstances as a result of the failure of a person to disclose a long position in a cash settled derivative of over 5%, there was a significant likelihood that the declaration could be challenged successfully.

One respondent submitted that to extend the GN to require disclosure of all long positions over 5% should be a matter for law reform.

Response

While the Panel’s powers are not necessarily as limited as the respondents submitted, the issue is not beyond doubt, so the Panel has referred in the GN primarily to control transactions. Paragraph 6 defines a control transaction and paragraph 10 of the GN explains that a control transaction will be considered by the Panel to have commenced when (as applicable):

- A proposal that is likely to affect control or potential control of a company is announced.

¹ For the purposes of the GN, a long position is defined as either a long equity derivative position or a relevant interest in securities or a combination of both.

- An acquisition of a substantial interest, such as an acquisition of 3% as part of a creeping acquisition, is announced.
- A proposed acquisition of a substantial interest is announced.

The Panel, however, also considered that there may be some circumstances involving the use of equity derivatives that are unacceptable in the light of the principles in s602 outside the context of a control transaction. Therefore paragraph 11 of the GN provides that the Panel may still wish to examine situations where a person holds a long position above 5% even though there is no control transaction.

Disclosure of derivative transactions

Comment

A number of respondents were concerned about the level of disclosure required in the draft GN. Two respondents pointed out that the nature of equity derivatives makes disclosure more difficult because it was less susceptible to an automated process. Some respondents provided a comparison with the requirements for disclosure in substantial holding notices.

Response

The Panel has clarified that it considers that the market will not normally need disclosure of the period of the derivative and the identity of the writer of the derivative.

Definition of derivative

Comment

A number of respondents submitted that equity derivatives over indexes or baskets of securities should not fall within the scope of the GN. Two respondents suggested that delta² disclosure of a derivative would provide a more accurate picture of the exposure to an individual security.

Response

Indexes were effectively excluded in footnote 8 of the draft GN. However paragraphs 13 and 14 of the GN now provide more guidance on indexes and baskets. Disclosure of derivatives over indexes are unlikely to give rise to unacceptable circumstances but derivatives over baskets of securities may give rise to unacceptable circumstances depending on the number of securities that comprise the basket. The Panel considered that disclosure of the delta of derivatives was not feasible given that the delta value of a derivative may change during the derivative's life.

² The delta is the rate at which a derivative's price varies with the price of the underlying security.

Market makers*Comment*

Four respondents submitted that there should be a market maker exception in the GN.

Response

Paragraph 60 of the draft GN excluded disclosure by the writers of equity derivatives, which was effectively providing for a market maker exception. Paragraphs 15 to 19 of the GN now provide more guidance on this issue.

Netting*Comment*

Two respondents submitted that the GN should allow netting of long and short equity derivatives.

Response

The Panel is concerned that equity derivatives, even over the same stock and between the same parties, may have materially different characteristics and netting of the positions could give a misleading impression. In the worst case, the netting of positions could be used to hide a material equity derivative position. The GN says that the Panel will not normally take into account the net position arising from short and long derivatives, except for exactly offsetting exchange traded derivatives. Moreover, lack of separate disclosure of a short derivative position in a disclosure of a long position may give rise to unacceptable circumstances.