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Brussels, 31st March 2010

Dear Mr Comporti,

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

CFA Institute is pleased to comment on the Committee of European Securities Regulators' (CESR) consultation on the proposal to extend major shareholding notifications to instruments of similar economic effect to holding shares and entitlements to acquire shares (the "Consultation").

CFA Institute, through its members' experience in international markets and different investment disciplines, represents the interests of investors and investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide. CFA Institute promotes fair, open, and transparent global capital markets, and advocates for investors' protection.

<u>Executive Summary</u>

CESR proposes a widening of the Transparency Directive (TD) to encompass instruments of similar economic effect to holding shares and entitlements to acquire shares in major shareholding notifications. Several Member States have already taken steps in the same direction regarding their national regimes. Hence, the proposal is an attempt to harmonize the measures taken across the EU.

- CFA Institute supports the Consultation's main objective to improve market transparency with regard to clandestine accumulations of shares through instruments of similar economic effect to holding shares and entitlements to acquire shares in major shareholding notifications. We support measures designed to improve market transparency based on fair disclosure of positions accumulated through the use of these types of instruments.

- In general, the concerns raised in this consultation are due to the use of such instruments to affect the takeover of a target company. Traditional investment funds

and companies do not engage in takeover activities, so the primary concern is a takeover by an operating company or private equity fund.

- We believe that public companies that acquire such positions also should have to disclose these positions under the Market Abuse Directive since they constitute material non-public information.

- We support a broad definition of these instruments. A narrow or specific definition based on an exhaustive list of instruments would only create an incentive to design new derivatives with the sole purpose to circumvent the actual spirit of the proposed provisions, thus reducing the effectiveness of the regulation.

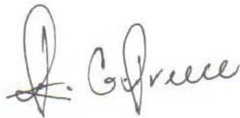
- Regarding the scope of these proposals, we favour the option cited in the Consultation that would limit the legal definition to the definition of financial instruments contained in MiFID. Alignment with MiFID would lead to greater harmonisation of definitions across Directives, provide greater legal certainty, and provide clarity for investors. It would also likely facilitate more consistent regulatory implementation across Member States.

- CFA Institute welcomes a harmonization of the calculation of thresholds and the aggregation of shareholdings, instruments of similar economic effect to holding shares and entitlements to acquire shares across Member States. We also support the delta-adjusted basis for the calculation of shareholding equivalence.

- Overall, we believe that the benefits from the proposed provisions in the form of increased transparency and the accompanying improvements in market efficiency would more than counterbalance the costs they may impose on certain market players.

We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,



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CFA Institute develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

Our responses to the Consultation's questions are set out below.

Reporting instruments of similar economic effect to holding shares and entitlements to acquire shares

Questions:

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?

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

The Consultation notes that instruments that create a similar economic effect to holding shares and entitlements to acquire shares effectively create a long economic exposure to an issuer. Such instruments are presently outside the scope of the Transparency Directive (TD).

CESR points out that these instruments may potentially be used to exercise influence in a company or allow for creeping control. CESR also notes that these instruments may be entered into in order to gain economic exposure to an issuer more generally without the intention to gain access to voting rights. As such, these instruments are a useful source of liquidity.

CESR further comments that the use of such instruments should not be discouraged. Rather, their resulting economic exposure should be made more transparent.

In order to capture their potential usage to exercise voting influence in a company or allow for creeping control, CESR proposes that the scope of major shareholding notifications under the TD should be extended to include instruments of similar economic effect to holding shares or entitlements to acquire shares. Examples of such instruments cited in the Consultation include Contracts for Difference (CfDs), equity swaps, cash-settled call options and the writing of put options.

CFA Institute agrees that instruments with similar economic effect to holding shares or entitlements to acquire shares can be used to influence or exert control over a company. The cases put forward by CESR under section IV of the Consultation are good examples of how these instruments can be used to exert influence over a company without requiring disclosure to the broader market. As these recent cases illustrate, such 'hidden ownership' can have a significant impact on the share price of the issuer as market participants act on incomplete information. These scenarios also highlight the wider governance issues associated with 'hidden' ownership.

In general, though, the primary concerns from these positions are the potential takeover of a target operating company through the clandestine acquisition of shares through a derivative instrument. As noted in the consultation, the VW/Porsche case represents a use of existing rules and regulations to achieve a takeover without tipping off the market to the acquirer's true intentions.

It seems to us that as companies invest scarce company resources into derivatives instruments rather than in operating upgrades, new products, or shareowner dividends, they should have to disclose such decisions to the market. In Porsche's case, the investments were successful and produced significant paper gains. However, if the market had fallen sharply instead, then not only might the investment have imperilled Porsche's financial condition, it also could have imperilled the financial conditions of VW and other significant shareowners.

Operating companies—as distinct from investment companies—whose shares are traded by investors either on a listed exchange or over-the-counter and who use derivative instruments to accrue such positions, therefore, should have to disclose those positions in their reported financial statements and in their near real-time market updates. Such matters have relevance to investors and shareowners for at least two reasons. First, shareowners have a right to know how company management is investing its liquidity, particularly when it is investing in potentially risky and volatile derivative instruments. Second, Porsche's shareowners invest in the company because of its prowess in manufacturing and marketing its automobiles. If its management has decided on a fundamental change in strategy toward one that invests significant portions of its liquidity and/or capital in derivatives instruments, then shareowners have a right to know about that change in strategy, even if the strategy is a one-off attempt to take advantage of market prices or to launch a takeover of a competitor.

There are, nevertheless, circumstances whereby an investment firm acquires a significant interest in the shares of an operating company. While it is rare that these investments will lead to a takeover, the accumulation of potential interest by such a firm is a point of interest to market investors. Because it is important to treat both types of acquirers similarly—operating companies moving toward a takeover and an investment firm that has

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acquired a significant interest for investment purposes—these interests should be disclosed to the market in the same manner through the mechanisms proposed herein by CESR. These disclosures would supplement rather than replace the disclosures by the operating company that we discussed above.

One also should bear in mind that these cases are somewhat extreme. The bulk of trades in the type of instruments in question are fully legitimate investing activities, such as hedging and risk management of underlying positions in a larger portfolio. As such, these instruments facilitate more efficient portfolio management.

CFA Institute supports measures designed to improve the transparency of positions accumulated through the use of these types of instruments. However it is important that any new provisions do not impose undue costs on investors – such as named public disclosure of certain positions – which could harm liquidity and thus the efficient functioning of the price formation process.

CESR proposes to apply notification thresholds based on the summation of positions in instruments that give a long economic exposure to an issuer with actual share holdings. We believe that this approach is appropriate and should improve market transparency without imposing undue costs on investors.

Broad definition

Questions:

Q3. 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?

Q4. With regard to the legal definition of the scope (paragraphs 50-52 above), what kind of issues do 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 definition of instruments that could trigger such disclosures should be broadly based. A non-exhaustive list could be provided to reduce the legal uncertainty as far as possible and provide guidance to market participants. However, any attempt to create an exhaustive list is likely to fail because, as the Consultation points out, it would only create an incentive to design new derivatives with the sole purpose to circumvent the actual spirit of the proposed provisions, thus reducing the effectiveness of the regulation.

With regards to the legal definition of the scope of these proposals, the Consultation sets out two options: (i) to extend the legal definition beyond the definition of financial instrument contained in MiFID, with the possibility of excluding certain types of transactions; or (ii) to limit the legal definition to the definition of financial instrument contained in MiFID. We favour option (ii). Alignment with MiFID would lead to greater

harmonisation of definitions across Directives, provide greater legal certainty, and provide clarity for investors. It would also likely facilitate more consistent regulatory implementation across Member States. Further, alignment with MiFID would simplify the legislative process and would be the least costly and most effective approach to implement the proposed provisions.

Calculation of thresholds

<u>*Questions:*</u>

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

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

CFA Institute welcomes a harmonization of the calculation of thresholds and the aggregation of shareholdings, instruments of similar economic effect to holding shares and entitlements to acquire shares across Member States.

We acknowledge the complications with the delta-adjusted calculation of share equivalence, most notably that it would have to be recalculated daily and that the threshold might be passed passively. At the same time we recognize that this is the method suggested in the short-selling rules proposed by the CESR Task Force. Further, the delta-adjusted approach allows for a more faithful representation of economic exposure. For example, an option that is deeply out-of-the-money would likely have a lower delta[1] than an option where the price of the underlying asset is in close proximity to the strike price. In the case of the former, the lower delta reflects the lower likelihood of the option being exercised. Multiplying the shares referenced in the contract by the delta would have the effect of lowering the economic exposure, perhaps below the notification threshold (compared to the nominal approach which would not account for the delta-adjustment). This approach best reflects economic reality. In contrast, the nominal approach does not account for the likelihood of the option being exercised, and therefore would have the effect of lowering the effective notification threshold. This also would result in a greater number of shareholding notifications.

Take the example where an investor buys options which are far out of the money. To gain any significant economic exposure she would need to buy a large number of options. With the nominal approach this could easily trigger a shareholding notification. The notification would however be misleading; the options are far out of the money, hence very unlikely to be exercised. In addition, the investor is not likely interested in acquiring the firm whose shares compose the underlying. If the option would move into the money, she would most likely take profit and liquidate her position. The delta adjusted basis would do a much better job here. When the options are far out of the money, no notification would be required, whereas as the option moves into the money and the investor holds on to her

[1] Delta measures the responsiveness of the option price to changes in the price of the underlying asset.

position, a notification would be triggered. We therefore strongly advocate the delta adjusted basis to avoid unnecessary disclosures with the potential to confuse market participants rather than provide them with useful information.

Scope of disclosure

Questions:

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 harbour' approach)?

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?

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

CFA Institute advocates a general approach to include all instruments of similar effect to holding shares and entitlements to acquire shares, combined with the existing TD exemption, set out in the Consultation, that excludes market makers or those acting in a market making capacity from disclosure if such market-making activities result in an acquisition or disposal crossing the relevant threshold. Even though the 'general approach' of broadly including all such derivative instruments might yield more disclosures than the 'limiting approach[2]', those disclosures under the general approach should naturally be limited by the applicable threshold and the use of the delta-adjusted basis. While the focus of the Transparency Directive is not the free float, from an investor's point of view the need for transparency is not limited to voting rights. To provide an easy means of circumventing the proposed provision through the use of contractual terms that exclude the possibility of obtaining the voting rights, as would be the case with the limiting approach, would, therefore, be unfortunate. Moreover, under the limiting approach it would be possible for the holder to acquire the shares, including the voting rights, from the writer once the instrument and the accompanying contractual terms expire.

[2] The Consultation defines a 'limiting approach' based on contractual terms that preclude the possibility of the holder obtaining the voting rights or influencing their exercise. Per the Consultation, this would mean that all instruments that potentially give access to the underlying voting rights would require disclosure unless stringent 'safe harbour' requirements are met. CESR sets out a number of concerns related to the safe harbor approach for certain types of contractual agreements, which CESR believes to be unworkable.

Costs and benefits

<u>*Questions:*</u>

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

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

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

We are convinced that, on a general level, the benefits in the form of increased transparency and the accompanying improvements in market efficiency would more than counterbalance the increased costs the proposed disclosure requirements may impose on certain market players.

31st March 2010.