ISDA. Safe, Efficient Markets

BY E-MAIL July 16, 2013

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Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
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Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
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Dear Sirs/Mesdames:

Re: Proposed Amendments to Multilateral Instrument 62-104 *Take-over Bids and Issuer Bids* and National Policy 62-203 *Take-over Bids and Issuer Bids* and National Instrument 62-103 *Early Warning System and Related Take-over Bid Insider Reporting Issues*

This comment letter is submitted in response to the Notice and Request for Comments (the **Request for Comments**) published by the Canadian Securities Administrators (the **CSA**) on March 13, 2013 with respect to proposed amendments to Multilateral Instrument 62-104 *Takeover Bids and Issuer Bids* and National Policy 62-203 *Takeover Bids and Issuer Bids* and National Instrument 62-103 *Early Warning System and Related Take-over Bid Insider Reporting Issues*. The International Swaps and Derivatives Association (**ISDA**) is grateful for the opportunity to respond to the Request for Comments. ISDA's mission is to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. ISDA has more than 800 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. For more information, visit www.isda.org.

We commend the CSA in its efforts to promote greater transparency regarding significant shareholding under the early warning reporting system. We are commenting on these proposals from the perspective of industry participants who utilize derivatives as a broad tool for a variety of purposes, including effective risk management, secondary market capital allocation, intermediation and efficient uses of leverage. We believe we are uniquely positioned to comment given that we represent a significant segment of market participants who utilize derivatives for such purposes. While we understand the policy reasons for expanding the disclosure requirements under the early warning system to encompass "equity equivalent derivatives", in our view, such policy reasons are not advanced by imposing reporting upon counterparties such as our members when undertaking activities for the types of "non-control" related purposes outlined above. We submit, therefore, a proposal for an exemption from reporting that would be designed to exempt parties who can objectively demonstrate a non-control intent in entering into equity equivalent derivative transactions.

We outline this proposed exemption referred to as the "**Protocol Exemption**," in Part I of our comment letter. We have provided our responses to certain specific questions posed in the Request for Comments in Part II of our letter.

As a preliminary matter, we wish to clarify that we are not commenting on the appropriate threshold for triggering the early warning reporting requirement (as proposed to be decreased from 10% to 5%). In our view, it is more appropriate for other industry stakeholders to comment on this aspect of the proposal. However, in we do note that imposition of a lower threshold along with expansion of deemed control or direction to apply to reference securities underlying equity equivalent derivatives will result in significant over-reporting in respect of transactions that are not subject, as discussed below, to the policy concerns outlined in the Request for Comments.

Given that the goal of the early warning regime is to expose transactions that may signal a potential acquisition of control of an issuer, expanding disclosure requirements to include transactions that have no connection to such policy objective will obscure information that is relevant. As we discuss in detail below, this is exacerbated by the volume of derivatives activity that is conducted, and by the fact that disclosure may be triggered by a number of participants in a chain of back-to-back derivatives transactions whose interests or objectives are not connected, in any way, to ownership or control of an issuer's securities.

Part I – Proposed Protocol Exemption

Protocol Exemption

We propose that ISDA would adopt a protocol (the **Protocol**) setting out standards that apply to transactions that would be exempt from the "proposed reporting obligations and restrictions" (and in this respect, reference to "proposed reporting obligations and restrictions" applies to the proposals under the Request for Comments to (i) expand the early warning reporting trigger to deem control or direction over reference securities underlying an "equity equivalent derivative," (ii) expand the moratorium provisions to apply to acquisitions of equity equivalent derivatives, and (iii) to require disclosure of deemed control over reference securities underlying equity equivalent derivatives, as well as of "related financial instruments" and transactions having the effect of altering "economic exposure," in each case, under the early warning reporting requirements generally as well as under the alternative monthly regime).

A Protocol is a multilateral contractual mechanism that allows for various standardized amendments to be deemed to be made to the relevant agreements between any two adhering parties. It builds on the principle that parties may agree with one or more other parties that certain terms and provisions will apply to their respective relationships (unless and until they specifically agree otherwise). ISDA has administered over 80 protocols since the creation of the mechanism in 1998. See here for further details on the protocol mechanism: http://www2.isda.org/functional-areas/protocol-management/about-isda-protocols/.

In respect of disclosure of related financial instruments and economic exposure, we note that, unlike other jurisdictions, Canadian regulators also impose concurrent "insider reporting" obligations. These obligations capture interests in related financial instruments and economic exposure in respect of parties who are deemed to beneficially own or exercise control or direction over 10% or more of the outstanding voting securities of a reporting issuer. We do not believe it is necessary to duplicate such disclosure under the early warning regime, specifically with respect to the entering into of an equity equivalent derivative for non-control purposes.

The Protocol would be designed to provide assurance that transactions subject to it are carried out in a manner that would obviate concerns regarding hidden (morphable) ownership and empty voting, as discussed in greater detail below. Individual contracting parties would elect to adhere to the Protocol and thereby confirm their intent to enter into applicable derivatives transactions solely for non-control related purposes (such as risk-management, secondary market capital allocation, intermediation and efficient uses of leverage, as outlined above) and not to evade reporting requirements. Applicable rules and other safeguards could be implemented to ensure, among other things, that an electing party remains bound by its election for a requisite minimum period of time in order to prevent any abuse of the "Protocol Exemption."

The Protocol would be designed to address the primary regulatory concerns outlined in the Request for Comments, being the ability of a party to accumulate an economic interest which is quickly convertible into a voting interest (**hidden voting**, also commonly referred to as "**hidden (morphable) ownership**") and the holding of voting rights with no equivalent economic stake (**empty voting**) through "contingent ballot" and "liquidation restriction" requirements. As explained below, the Protocol would achieve this by isolating swap participants whose objectives do not relate directly or indirectly to influencing or exercising any voting or investment control and provide them with an exemption or "safe harbour" from reporting so long as they comply with the Protocol. (The Protocol would be available for swaps that constitute "equity equivalent derivatives," which we are assuming generally when we refer to "swaps" in this letter.) We believe this would be beneficial to all market participants as it would allow the CSA to expand the reporting requirements as proposed while eliminating some of the over-reporting that will result, thereby permitting issuers and others to better focus on transactions and parties that actually have or propose to acquire controlling interests. This is particularly significant given that over-reporting would likely lead to the issuer not knowing who actually has the intent to control.

Contingent ballot to eliminate potential voting influence

Under the Protocol, to the extent a counterparty to a swap transaction has hedged its position by acquiring the underlying reference securities, such counterparty would agree to vote those securities proportionately on the same basis as other holders of the securities, not including the other counterparty to the transaction. In this manner, any potential influence that a swap counterparty that has a long position may have would be eliminated since the reference securities would be voted in a manner that reflects the voting preference and pattern of all other beneficially holders generally of the securities (i.e., traditional long investors whose interests are, arguably, aligned with the corporation and its stakeholders generally).[1] While the technical details of such a "contingent ballot" require further discussion, we envision it would involve participation of proxy intermediaries and for the counterparty with the long position to undertake to disclose the number of shares that are beneficially owned, or over which control or direction is exercised on the record date by such party and its joint actors, and provide an irrevocable commitment on how it intends to vote. We also acknowledge that further consideration may be required in determining whether the Protocol would need to provide for a secondary "no vote" option. While we propose the contingent ballot as a safeguard, we note that the standard market practice in derivatives activities undertaken for non-control purposes is not to exercise any such actions or take instructions from the swap counterparty.

Liquidation restriction

The second component of the Protocol Exemption would focus on the counterparty with a long position on the swap and be designed to address the concern that an investor may be able to convert its synthetic economic interest in an issuer into voting securities through the use of equity swaps or similar derivative arrangements. Under the Protocol Exemption, such counterparty would irrevocably undertake not to liquidate its synthetic position under the swap while being in the market as a purchaser of the same securities at the same time. The technical details of the Protocal Exemption would include relevant safeguards relating to timing, irrevocability and application to joint actors, etc., to prevent any abuse of the exemption.

We believe that the Protocol Exemption could be designed in such a manner so as to effectively isolate swap counterparties who are not contracting for the purposes of exercising voting or investment control by giving them an option to demonstrate such a non-control intent by committing in advance to (i) vote any reference securities acquired alongside traditional long shareholders and (ii) not attempt to influence any acquisition or disposition of the reference securities.

[1] We recognize that such a formulaic approach may result, to an extent, in incrementally exaggerating the voting power of significant shareholders (i.e., large block holders). However, we do not believe this raises any significant policy concerns given that the economic incentives and interests of such shareholders would generally be aligned with those of other long shareholders.

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We further believe that the Protocol Exemption is in line with the policy objectives of the early warning system in that it would permit regulators to focus the reporting requirements on the types of parties and transactions in respect of which greater transparency is sought. In our view, as discussed elsewhere in this letter, given the nature of the derivatives market, failure to devise a sufficiently narrow and focussed regime will result in significant over-reporting. This risks impeding the underlying objectives of greater transparency, as regulators and market participants alike would not be able to distinguish between control and non-control investors or otherwise focus on disclosure that is relevant to them.

Part II – Responses to Specific Questions

In respect of the specific questions that have been posed we note generally that the introduction of the concept of an equity equivalent derivative and the deemed ownership or control of reference securities underlying such equity equivalent derivatives must be further considered in light of the practical realities of how such instruments and the relationships among the parties to such transactions are structured. These include issues relating to application and propriety of the "delta 90" test,[2] over-reporting resulting from the inability to calculate and report on a net basis and the need for broader exemptions from the moratorium restrictions to permit market-making and closing-out of pre-existing trades.

For example, in our view, the delta 90 test in itself is not adequate to address the complexities of how equity equivalent derivatives are structured. In particular, it raises many issues in determining how the test would be interpreted and applied. These include: (i) issues arising from the fact that the delta of an equity equivalent derivative may change during the life of a trade (therefore, the test should be applied as of the trade date); (ii) choosing among different models for determining the delta, including that different parties may use different implied volatility and other assumptions (e.g. dividends, interest rates, etc.) in making such determinations, and a range of acceptable methodologies exist that generate a range of implied volatilities and the related delta; and (iii) issues in applying the delta 90 test in the context of different types of transactions such as cash settled options, long dated options or European-style options.

While the foregoing comments apply generally to the proposed amendments, we note them specifically in response to questions 6 and 7. We have set out further specific responses to question 2 (b) and 14 below.

In response to question 2 (b), we do not believe that the moratorium provisions should apply to the acquisition of equity equivalent derivatives where the counterparty is transacting on a passive or non-control basis. The moratorium is intended to provide a "cooling off" after disclosure is made to enable the market to absorb information about a potential active investor. The policy objective underlying the moratorium provisions would not be advanced by imposing such a cooling off on passive and non-control derivatives counterparties. As discussed above, the Protocol Exemption would provide an objective basis for distinguishing among passive, non-control counterparties and control-seeking investors, thereby also

[2] We use the term "delta 90 test" to refer to the condition set out in proposed NP 62-203 where the CSA have stated that they would generally consider a derivative to substantially replicate the economic consequences of ownership of a specified number of reference securities if a dealer or other market participant that took a short position on the derivative could substantially hedge its obligations under the derivative by holding 90% or more of the specified number of reference securities.

providing a basis for an exemption from the moratorium provisions. Further, outside of the Protocol Exemption, we submit that the exemption under s. 10.1 of NI 62-103 in respect of market making should be extended to permit parties to close out pre-existing trades and carry out other similar activities.

In response to question 14, in our view, as discussed throughout our letter, a vast majority of derivatives counterparties enter into such transactions for purposes other than acquiring the reference securities at a future date. The deeming of acquisition of control or direction over underlying reference securities upon the acquisition of an "equity equivalent derivative" would result in significant over-reporting since it would apply to all such parties. Further, over-reporting would be exacerbated by the fact that multiple parties may be involved in swap transactions relating to the same reference securities, none of whom may have any intentions to influence or exercise voting or control. For example, if a hedge fund were to purchase a swap from Bank A, who in turn purchases the swap from Bank B, who in turn purchases the swap from a Canadian pension plan (whose ultimate purpose is to be short this company), the proposed amendments may require each of these parties to report, thereby obscuring the truly relevant information regarding voting control. In our view, market integrity is compromised when synthetic exposure is swept into actual ownership disclosure regimes. The result is that the investing public cannot see who may actually influence the company.

This would not be mitigated by reliance on the AMR regime given that not all such parties will be "eligible institutional investors" and even under the AMR regime, such deemed control would apply to trigger reporting and require disclose. Therefore, under the AMR regime as well, significant over-reporting would result thereby forcing regulators and other market participants to struggle with focussing on relevant disclosure while attempting to distinguish among passive, non-control investors and control-seeking parties. Further, for eligible institutional investors, this would also increase reporting and compliance costs with no commensurate public benefit. For these reasons, we propose that the Protocol Exemption should apply to both general early warning reporting requirements and under the AMR regime.

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ISDA appreciates the opportunity to provide its input on the Request for Comments and would be pleased to work further with the CSA in considering the Protocol Exemption or on any other matter relating to the Request for Comments. Please feel free to contact the undersigned at your convenience.

Yours truly,

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