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Equity Derivatives Assessment
Corporations and Financial Services Division
The Treasury
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ISSUES PAPER "IMPROVING AUSTRALIA'S FRAMEWORK FOR DISCLOSURE OF EQUITY DERIVATIVE PRODUCTS"
SUBMISSION BY SECURITIES & DERIVATIVES INDUSTRY ASSOCIATION (SDIA)

Introduction

The Securities & Derivatives Industry Association (SDIA) is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. It has 67 members accounting for 98% of market turnover by value. SDIA is pleased to provide this submission to Treasury on the Issues Paper "Improving Australia's Framework for Disclosure of Equity Derivative Products" of June 2009 ("the Issues Paper").

SDIA's members have a strong commitment to maintaining the integrity and high standing of Australia's securities market. We support the existence of a sound regulatory framework for the disclosure of substantial holdings of listed companies and managed investment schemes as a valuable element of maintaining the high standing enjoyed by the Australian market and the continuation of investor confidence.

Preliminary Comments

We note that the Government wishes that the review be comprehensive in relation to the whole diverse range of instruments that can be defined as equity derivatives. We acknowledge the benefits of a comprehensive review, in considering all products to ensure there is no regulatory gap.

As a preliminary matter, SDIA notes the Guiding Principle at [22.4] of the Issues Paper, namely "*Balancing Costs and Benefits*". SDIA urges Treasury to be particularly mindful of the potential cost impact of any changes that are suggested with respect to equity derivatives disclosure. Any additional requirements should only be imposed where there is strong evidence of market failure and where existing requirements have been shown to be inadequate. New proposals should be proportionate to the outcome sought to be achieved, and any additional cost burden should be minimized as far as possible.

The last twelve months has seen a significant range of new regulatory obligations introduced, which have resulted in a considerable increase in compliance costs being imposed on market participants, particularly on stockbrokers. This includes the short selling and stock lending disclosure obligations, which have generated significant costs through system changes and ongoing compliance costs. Some of these costs are still being incurred, as the changes have not yet been fully enunciated. These additional costs have been introduced in a period when market participants have been subject to acute revenue and financial pressures.

On the question of issues relating to the use of equity swaps in the situation of a corporate control transaction, we note that these were considered at considerable length by the Takeovers Panel in recent years in and around the well known case involving the takeover of Austral Coal, and in subsequent litigation. As noted in the Issues Paper, this resulted in the release by the Takeover Panel of TP Guidance Note 20.

Under that Guidance note, in connection with a control transaction, a party must disclose positions held under an equity swap together with physical holdings where the combined positions exceed 5%, or risk the declaration by the Panel of unacceptable circumstances. Since those events, there have not been any further cases to our knowledge where these issues have arisen, and there have been instances where parties have reported combined physical and derivative holdings in the context of takeover action.

It is therefore not clear whether there actually is any residual regulatory gap following these developments, justifying any significant further regulation of this area. It is likely in our view that the Takeover Panel's actions have satisfactorily addressed the regulatory risks that may arise on this question, and that the takeovers provisions are not being circumvented by the use of derivatives.

Set out below are our comments addressing the specific questions in the Issues Paper.

Questions

i. ***Does the list of equity derivative instruments covered provide adequate scope for this assessment to determine the effectiveness of the current regulatory regime?***

ii. ***Should the assessment investigate particular equity derivative instruments or should equity derivatives be broadly defined?***

The list of equity derivatives set out in the Issues Paper is comprehensive. There are no relevant instruments that have not been included.

In SDIA's view, the scope of the assessment should not extend to all instruments falling within the ambit of the term "equity derivatives". We believe that the assessment should be limited to consideration of cash settled equity swaps and CFD's.

SDIA's view is that there are no regulatory issues arising with respect to warrants. These instruments are currently well covered by the substantial shareholding provisions of the Corporations Act, as amplified by ASIC Regulatory Guide 143. As the substantial shareholding provisions stand, an interest under a warrant would in relevant cases fall within the definition of a "relevant interest" and would therefore need to be disclosed in any substantial shareholding or tracing notice. The extent of these obligations has been clarified from a regulatory perspective by ASIC RG 143. There is no gap, and no instances of regulatory failure of which we are aware, in relation to these instruments.

The question of exchange traded options ("ETO's") has been the subject of previous consideration by legislators. ETO's have been expressly carved out of the concept of a relevant interest by section 609(6) of the Corporations Act until that point in time when the right to the security is crystallised by exercise of the option.

ETO's are frequently used for purposes of hedging against offsetting positions, including physical holdings, or for trading purposes. ETO's are frequently closed out by offsetting purchases/sales of the opposite instrument. Issues of control of securities will frequently not arise. The relevant time when there is sufficient control for regulatory purposes, in our view, is upon exercise.

This position under section 609(6) position has been taken after careful consideration of policy grounds, and in our submission, it strikes the correct balance between regulatory concerns and regulatory burden. Requiring the reporting of all ETO positions would result in a significant increase in the frequency and complexity of daily reporting, particularly by market intermediaries, resulting in an increased regulatory burden, with no significant benefit. We submit that the position regarding disclosure of ETO's should remain as it presently stands.

Similarly, there are no regulatory issues arising in relation to options over unissued shares, or company options. No control issues can arise with respect to shares that have not been issued, and at present, a relevant interest does not arise until the shares are issued. This does not warrant any different treatment.

As indicated in the Issues Paper, individual share futures are no longer traded on the Sydney Futures Exchange and do not warrant any further examination. We agree with the Issues Paper that Index-linked derivatives do not give significant control over a particular company and hence do not warrant further consideration under this assessment.

Questions

iii. ***What are the practical differences in disclosing positions in OTC contracts and exchange-traded contracts?***

iv. ***Should exchange-traded contracts, OTC contracts or both types be considered? Please explain.***

Regarding (iii), please see the answer to (ii) above. The volume of ETO transactions would necessitate increased frequency of reporting and significantly increase the complexity of existing reporting. As indicated above, the predominant use and trading of ETO's does not impact on issues of corporate control, and therefore the information generated by requiring this information to be reported would tend to mislead the market rather than inform it.

Regarding (iv), please see the answer to (i) and (ii) above. Exchange traded contracts do not warrant further consideration under this assessment.

Questions

v. *Treasury is interested in further data and would welcome additional information about the usage, purpose and types of equity derivatives in practice.*

vi. *Treasury is interested in common forms of cash-settled equity derivatives such as equity swaps and CFDs.*

: *How commonly are these instruments used?*

: *When are they most likely to be used?*

: *Why is their use more prevalent now?*

Derivatives offer a number of advantages which encourage their use. The most notable advantages are:

- Use as a hedge against adverse price movements
- the ability to lock in a price for a future transaction
- leveraged exposure to the underlying security
- reduced transaction costs and administrative burden (e.g. custodian fees) when compared to physical transactions and holdings. This is a particularly advantageous for offshore investors. Derivatives can allow exposure via a single currency.

The use of equity derivatives has increased with the increase in sophistication of risk management and the increase in the global flow of investment funds.

The growth in the use of CFD’s (excluding equity swaps) has been furthered by their increasing availability to retail investors and their quotation (in some cases) on stock exchanges (including, for example, the ASX exchange-traded CFD’s).

Questions

vii. ***To what extent are equity derivative instruments used to avoid ownership disclosure requirements in practice?***

viii. ***Has this resulted in the market being inadequately informed? If so, please explain in what way.***

As mentioned earlier, exchange traded warrants incur the obligation to disclose positions, and therefore would not afford any assistance to a person seeking to avoid ownership disclosure requirements.

There is the potential that ETO's could be utilized to acquire a position in a security that would not be required to be disclosed until exercise. We are not aware of any reported cases in recent years where this has been alleged, and we note that the Takeovers Panel has reserved the right to consider this as potential grounds for making an unacceptable conduct declaration.

In relation to equity swaps and CFD's, SDIA is not aware of any research or statistical evidence as to the reasons given by entities entering into such contracts. Therefore, it is impossible to say whether these instruments are or have been used to avoid ownership disclosure requirements, as opposed to the variety of other reasons why the party would wish to enter into such an instrument e.g. hedging a physical position, a preference for the advantages of an exposure in synthetic form as against the disadvantages of carrying a physical holding. It should be noted that equity swaps and CFD's are not always fully hedged, so that the potential for derivative exposure to be viewed as offering some form of control over physical shares would not exist in all cases. See also the answer to (xii) and (xiii) below.

There have been some reported cases, including the case in relation to the takeover of Austral Coal that led to the issue of Guidance Note 20 by the Takeovers Panel, and the case of Rubicon Ltd in New Zealand. Under GN 20, substantial holders are now required to disclose derivative positions in their combined substantial shareholding positions in the context of a control transaction. At least in relation to control transactions, there is arguably no longer much scope for avoiding ownership disclosure, except in less than substantial amounts, unless the Takeover Panel's requirements are not complied with.

We are not aware of any recent issues of perceived regulator failure since that time, so query whether the issue remains an active one (although takeover activity has been reduced in the light of current economic conditions). There have been instances where parties have disclosed the existence of derivative positions to the market since that time, within the scope of GN 20.

Outside of control situations covered by GN 20, there is a question whether the absence of information about derivatives positions leads to market failure in relation to pricing of securities generally, as opposed to information relevant to control situations. We note that at parag. [22.2] of the Issues Paper, there is a reference to the potential outcome of derivatives disclosure being "*Better pricing signals:* greater disclosure should promote more informed pricing".

We note that this question was considered by the FSA in the UK in the course of its recent review of this same area under the title Disclosure of Contracts for Differences. The FSA's conclusion was that there was "…..no evidence of any market failure in respect of inefficient price formation caused by lack of transparency of CfDs." (see para. [2.10] Consultation Paper CP 08/17). We are not aware of any such evidence, and believe that the FSA conclusion is likely to be correct.

Questions

ix. *Do substantial cash-settled equity derivatives transfer significant effective control over shares? If so, how?*

We refer to para. [9] of the Issues Paper setting out the ways in which effective control might be obtained by a party holding a long equity derivative position. It would be impossible to rule this out as a possibility. Outside of the reported cases referred to where this has been alleged, we have not been made aware of concrete examples of such effective control being obtained in practice, or of market failure occurring, and the argument that these occur would appear to be based on anecdotal conclusions.

x. *Have you seen instances of market failure as a result of non-disclosure resulting from the holding of equity derivatives? Where possible, please provide details of the case.*

See answer to (ix) above.

xi. *Can equity derivatives give certain investors undue advantage in gaining interests in companies without having to disclose these interests? What are these advantages?*

See answer to (ix) above.

xii. ***It appears that issuers of equity derivative contracts typically hedge their positions by acquiring the referenced shares. In practice, are there instances in which this does not happen? Is this typically required by the contract or by internal risk protocols?***

This question can only be answered in general terms. For reasons of prudent risk management, for an issuer of a derivative to not hedge an exposure under the instrument would involve a potentially significant risk to the issuer, which could trigger a range of consequence, including capital requirements, quite apart from the potential risk of loss. An issuer could be expected to ordinarily seek to minimize this risk. Having said that, equity derivatives including swaps and CFD's are not always hedged, or not always hedged by a holding of the referenced shares or the full amount of the referenced shares.

There may be potential cases where the acquisition of underlying share could be delayed if a view were to be taken on the direction of the price of the shares. A risk decision may be taken by acquiring a partial hedged only. There may be cases where the referenced shares are not easy to obtain, but adequate protection could be obtained through the acquisition of a different company's shares offering a very similar profile. In some cases, an index may be used as a "parallel" hedge.

In addition, an issuer's exposure under an equity derivative could be hedged by another derivative with a different counterparty, rather than by holding a physical shares as a hedge.

Questions

xiii. ***If there is physical hedging by the counterparty, how common is it for the taker to be aware of this hedging?***

This question can only be answered in the most general of terms. Derivative instruments will usually only talk about referenced shares or some such term, and there will be no terms requiring the writer to disclose to the counterparty whether or not they will hedge their exposure with physical shares or to what extent. The writer will ordinarily also refuse to engage in any discussions with respect to any hedge that might or might not exist. Whether there are instances where there is a departure from this ordinary practice is not something on which we are able to comment.

Given the existence of prudent risk management practices, a taker might generally assume that the writer will hedge any exposure by acquiring the underlying shares, however this would be an assumption only. See the answer to xii. above in relation to the potential that hedging may not involve acquiring the actual subject shares.

Swap exposure may sometimes be offered by an issuer to a potential customer on the basis that the issuer offers the taker an exposure with respect to a certain number of referenced shares each day at a certain price, which may cause the taker to assume that this reflects the extent to which the writer has been able to first acquired the shares in order to be prepared to offer the exposure. Again, this would be an assumption only on the taker's part, and there would ordinarily be no confirmation in these cases that any hedge had in fact been acquired.

Questions

xiv. ***In practice, do counterparties in equity derivative contracts typically issue voting instructions to the direct holder of the referenced shares, or seek to influence voting in any way?***

We refer to the answer to (xii) and (xiii) above in relation to the ordinary practice of not acknowledging the existence of any hedge. We cannot comment on the extent to which there may be departures from the ordinary practice in certain cases, in which voting instruction are given with respect to referenced shares or attempts are made to influence voting, contrary to express provisions of the swap documentation. If this were to occur, then there would be grounds to argue that such an arrangement would give rise to an association which would most likely trigger the relevant interest provisions under the takeover and substantial shareholding provisions that already exist.

Questions

xv. ***It appears that cash-settled equity derivatives present the main challenge to the current ownership disclosure framework. Do the features of delivery-settled contracts also present similar or other problems for disclosure? If so, how?***

We would have thought that the position of a delivery-settled contract, derivative or otherwise, would be fairly clear. Subject to the terms of the particular contract, a delivery-settled contract would ordinarily most likely fall within the concept of a "relevant interest" under the Corporations Act, and an interest in the subject shares would be required to be disclosed in any substantial shareholding notice or in answer to any tracing notice.

Questions

xvi. ***The existing ownership disclosure regime requires disclosure of voting interests in shares. Would disclosure of short derivative positions have any***

benefit to market transparency? Would it be desirable only where an offsetting long equity or long derivative position has been disclosed? What are the advantages of disclosure of short equity derivative positions?

In SDIA's view, there is no benefit to be gained from disclosure of short derivative positions. There is no ability to translate a short position under a typical equity derivative into any form of control over underlying shares or voting rights attached to shares, and therefore there is no benefit to be gained from imposing the additional reporting burden of disclosure requirements with respect to short derivative positions.

We note that the recent review carried out by FSA in the UK considered this issue in the course of its Consultation (CP 07/20), and came to the same conclusion in deciding that short derivative positions should not be required to be disclosed (see [2/14], CP 08/17).

Questions

xvii. ***How common is 'empty voting'? Does this practice undermine the fairness and transparency of the market?***

We refer to the para. [56] of the Issues Paper. We are not aware of any views expressed in the market that the exercise of the right to vote by a shareholder who may have entered into a short derivative position in relation to those shares is regarded as inappropriate or misleading.

One of the accepted advantages of equity derivatives is risk minimization. Parties may seek to protect themselves against the risk of a fall in price by entering into a short equity derivative in respect of those shares. The only result of the dividend is that they will receive a cash payment on termination of the derivative in the event that the price of the shares has fallen. They will still remain the owner of the shares, albeit at a lower price, and properly entitled to exercise the right to vote.

There is no evidence that lack of transparency of derivatives is essential to efficient price formation. See answer to question viii above.

In any event, to the extent that the issuer of the short derivative to the shareholder in this instance will enter into a short sale of underlying physical shares to hedge its own exposure, there will be transactions in the market that will contribute to efficient price formation for the company's shares.

Questions

xviii. ***If substantial holder notice provisions were to be expanded to include equity derivative positions, would there still be a regulatory gap that allows equity derivative holders to circumvent takeover provisions?***

If the substantial shareholder provisions were to be expanded to include the reporting of equity derivative positions as part of combined holdings, and assuming that those positions were reported as required, then it would be difficult to see how there could be any regulatory gap.

The problem would rather be whether this would generate excessive frequency of reporting, and whether (as we would argue) this extra reporting would result in extra “noise” rather than quality information, particularly given that in most cases, the derivative position is unlikely to result in any effective control over the subject company. There would be a question of whether the extra information could actually mislead the market.

Questions

xix. ***Would such a gap be a problem in practice?***

See answer to (xviii) above. There would be no gap in this instance.

Questions

xx. ***To what extent could the market be relied on to price in a control premium, thereby sufficiently rewarding shareholders with the premium that an acquirer of direct stakes normally has to offer in a takeover bid?***

xxi. ***Would there be scope for the Takeovers Panel to address these issues when they arise in practice?***

There would be no difference in this instance to the way in which the market currently reacts to information disclosed by a holder once they reach the 5% threshold. A control premium will usually be priced into the security once such a disclosure is interpreted as creating the potential for a control transaction. The Takeovers Panel will be able to address control issues as it already does in practice in relation to physical holdings either on their own or in connection with derivative positions in a control situation.

Questions

xxii. If substantial holder notice provisions were expanded to include equity derivative positions, should the law be amended so that positions over 20 per cent must also comply with the takeover provisions? Should the assessment consider whether the takeover provisions in the Corporations Act 2001 would benefit from an expansion to include equity derivatives holdings?

There is an argument that it may be taking things too far to expand the takeover laws such that the 20 per cent threshold can be triggered by a combined physical and derivative holding.

The existing Takeover Panel position with respect to combined physical and derivative positions in the context of a control transaction, as mentioned earlier, would require that the combined position in this instance would have been required to be disclosed, otherwise the Panel may well declare unacceptable circumstances to exist. On this basis, existing market regulation should ensure that the market is informed of derivative positions of substantial size in situations where that information is most relevant, namely in connection with a control transaction, and that therefore no change to regulation is needed.

If an obligation to disclosure derivative positions in connection with substantial shareholding requirements was to be introduced, then this would further ensure that the market was aware of the accumulation of substantial positions not only in connection with control transactions but on an ongoing basis.

If the Takeover provisions in the Corporations Act were to be expanded so that the full effect of the takeover laws applied to such combined holdings, there could the potential that the consequence might operate unfairly in certain cases. For example, a party might have a combined physical and derivative holding which exceeded 20%, made up of, say, 12% relevant interest in shares and an economic interest in the equivalent of 9% of shares under a cash settled equity swap. The party may have no ability to control the voting or disposal of the counterparty's hedge (as would be the case under the usual terms of an equity swap), may not seek to influence the voting or disposal by the counterparty, and the swap may be cash settled on termination without the party acquiring, or even seeking to acquire, any of the shares from the swap counterparty upon termination. If the takeover laws were to apply as suggested, criminal and civil consequences including forfeiture could have been incurred by the party, without there being any attempt by the party to seek control over the company.

SDIA would also highlight the potential issue of amendments to the takeover provisions triggering possible flow-on effects on the foreign investment laws. A position under a derivative should not be counted within a position triggering approval requirements under FIRB rules.

In our view, regulatory objectives in this area would be adequately served by ensuring that the market is aware of the size of substantial derivative positions in connection with control transactions, as is currently achieved by Takeover Panel rules. To the extent that it might be considered that the existing Takeover Panel provisions are not thought to be sufficient, then introducing more general disclosure obligations would most likely satisfy any perceived shortcomings. However, applying the full range of the Takeover provisions could be seen to be an unnecessary extra step.

Questions

xxiii. ***Do companies that issue shares on the market require information about equity derivative contracts that reference substantial parcels of their shares?***

We would imagine that a listed company may want access to as much information as possible in relation to activity in and around its shares if that information were freely available. Presumably, companies would like to have access to information about derivative positions in their shares in addition to the existing information about substantial shareholdings and information about relevant interests arising from the use of tracing notices.

However, an important question is whether the interests of a listed company in knowing as much as possible about derivative positions is reason in itself justifying the introduction of a disclosure regime, or the level of or the circumstances in which disclosure should reasonably be required, having regard to the cost of doing so. Please see also our answer to xxiv. Immediately below our comments as to the potential that may exist, based on existing experience, for listed companies to make excessive use of tracing notices to obtain information about derivatives positions if that avenue were available.

Questions

xxiv. ***Should the assessment consider extending the tracing notice provisions to include equity derivatives?***

The existing tracing provisions are already quite complex and involve significant costs of compliance. The compliance cost burden falling on stockbrokers and investment banks is particularly high, given the variety of capacities and types of businesses for which shares and relevant interests in shares are held.

There has been a significant and increasing trend for parties to serve tracing notices on a frequent, routine and repetitive basis, quite unrelated to any actual or anticipated control transactions on foot in relation to a company. Issuers, particularly those using third party share registry advisers, frequently serve tracing notices every few days, which arguably is a misuse of the tracing provisions.

There has been a long overdue need for these obligations to be streamlined, to permit some relief in relation to holdings which are purely client driven and/or result in no effective control. There is also a long overdue need for the statutory fees for answering tracing notices to be updated to reflect the actual cost burden involved in answering such notices on a routine basis, and the passage of time since the level of fees was last reviewed.

In our view, the interests of the market in being informed ought to be satisfied by disclosure of overall combined positions that are of substantial size. There is no benefit to be gained from the ability to obtain information regarding smaller derivative positions.

If the tracing notice provisions were to be extended to include derivative holding, this would exacerbate the complexity of answering these notices and the compliance cost for little or no corresponding benefit. We would therefore argue against extending the tracing notice provisions in this way. Further, if extending those provisions is to be considered, then it should be accompanied by a thorough review of how those provisions are currently being utilized, and of the ongoing resource and compliance issues currently being experienced.

Questions

xxv. *Are you aware of instances of directors covertly accumulating or disposing of interests in companies through the use of equity derivatives?*

xxvi. *Should the assessment consider expanding the relevant legislation to incorporate equity derivative holdings in director disclosure provisions?*

xxvii. *The scope of this assessment excludes short equity derivatives. However, should an examination of expanding director disclosure provisions to provide investors with information about any director holdings of short equity derivatives be considered? What risks might this pose?*

Regarding (xxv) - (xxvii), we would comment on these issues in a general way. There would no doubt be instances where directors of listed companies may seek to use derivative strategies in relation to their shareholdings in the companies of which they are a director as a means of risk management or diversification. One example is the writing of a swaps or call warrants to protect against the downside risk of a falling share price, a strategy which could be used by any shareholder.

Other "monetization" strategies could involve the use of derivatives to provide the director with exposure to a broader range of stocks, thereby diversifying concentrated exposure to a single stock to exposure to a range of stocks. It would be incorrect in our view to label such strategies as "covertly disposing of interests" in the relevant company.

Whether there are particular considerations relating to directors of listed companies that result in this being either appropriate or inappropriate from a policy perspective is something that we would leave to the broader corporate governance community to debate.

Additional Comments

As mentioned at the outset, SDIA urges Treasury to carefully consider the costs implications of any additional reporting requirements that may be considered in relation to disclosure of derivatives, and balance the benefits of any new requirements against regulatory burden.

Recent regulatory changes have placed an additional cost burden on financial intermediaries, particularly stockbrokers and investment banks. In connection with any proposed requirements in relation to derivatives disclosure, SDIA strongly urges Treasury to introduce appropriate carve-outs from disclosure obligations in two key areas, namely intermediaries with client-facing derivatives business, and where in relation to derivatives between companies within the same group.

Intermediaries who issue a derivative in response to client demand could not be regarded as seeking control of the underlying shares. The direction of any position whether long or short, is driven by customer demand, which will generate the termination of the position as well as the opening. It is also difficult to envisage there being any significant risk that a financial intermediary who takes long derivative position in response to client demand might be in any position to exercise any control over any physical holding that the client may have, thereby justifying the need to report that derivative position. It would be appropriate for there to be an exemption from any disclosure requirements extending to any derivative positions opened or closed as a result of market making/client facing activities.

In relation to intra-group derivatives, quite commonly one entity will issue a derivative, but then the exposure will be backed out in one or more transactions within the group, for various reasons connected with the group's structure and organization of its derivatives business, accounting and tax considerations. If the derivative position is required to be disclosed, then it should only be required to be disclosed once. Requiring the same position to be disclosed on a multiple basis by each entity within the group would lead to over-reporting, excessive complexity of reporting, and potential misleading of the market.

These two areas were acknowledged as warranting a carve-out by the FSA in its recent review of Disclosure of CfD's [see p12, CP08/17], and those carve-outs have been incorporated in the UK disclosure regime due to commence shortly. SDIA submits that such carve outs would assist in minimizing the cost burden of any new requirements that may be considered without jeopardizing the quality of information resulting from any new disclosure regime in Australia.

We would be happy to discuss any issues relating to this matter at your convenience. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@sdia.org.au .

Yours sincerely,

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