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BY POST AND E-MAIL

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Policy – Primary Markets
Financial Services Authority
25 The North Colonnade
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London E14 5HS

12 February, 2008

Dear Simon,

Disclosure of Contracts for Difference

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] is grateful for the opportunity to comment on the Financial Services Authority ("**FSA**") Consultation Paper 07/20, "Disclosure of Contracts for Difference: Consultation and draft Handbook text". The Consultation Paper addresses various perceptions and misperceptions about cash-settled equity derivative transactions, and we welcome the opportunity to clarify the position from a market practitioner perspective and to express our views on the policies that should apply in this area. We are grateful for the careful and considered tone of the Consultation Paper, the thorough preparation that was undertaken before it was issued and the clear desire it expresses to frame a sensible and proportionate regime for disclosure of cash-settled equity derivative transactions.

Perceived market failures

As you indicate in the Consultation Paper, the FSA believes it would be unacceptable if, without there having been any timely disclosure to the market or to the issuer of the shares of any prior arrangement, a holder of a contract for difference ("**CFD**"):

1) at the end of the term of the CFD, acquired shares held as a hedge by the CFD writer, or

2) where a CFD writer exercised voting rights under hedge shares in accordance with the instruction of, or at any rate under pressure from, the CFD holder.

[1] ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association by number of member firms. It was chartered in 1985 and today has over 825 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

As you know from our prior discussions, our members believe that the current major shareholding disclosure regime under the Disclosure and Transparency Rules is adequate for the purpose of "flushing out" the existence of any agreement or arrangement by which a CFD holder may be entitled to acquire any underlying hedge shares or to exercise or control the exercise of voting rights in respect of any such shares. In our view, if there is truly any market failure in this context (and the Consultation Paper offers, in our view, relatively little firm evidence that there is any such market failure), it should be capable of being addressed through stricter adherence to and enforcement of the existing regime.

For this reason, we believe that there is a perfectly clear and strong case to be made in favour of Option 1 in the Consultation Paper, namely, leaving the current disclosure regime as it stands. We therefore urge you strongly to re-consider Option 1.

You have also asked, however, for views on Options 2 and 3, and so we set those out below. We must, however, stress the following: given the nature of the misperceptions that are demonstrably influencing this debate (and in order not to feed those misperceptions), if the FSA does take further steps in this area, it will be vital to state clearly the rationale for and the objectives of any such action.

Clear preference for Option 2

As between Option 2 and Option 3, the consensus view of our members is that Option 2 is:

- the more sensible and proportionate approach;
- adequate to address the question of perceptions referred to above for any reasonable observers;
- sufficient to address the occasional and non-systematic use of CFDs to influence voting or build stakes; and
- considerably less burdensome and less likely to impose unnecessary constraints on the efficiency of the market or to distort its operation.

We agree with the comparisons you have drawn regarding the comparative costs and benefits of Option 2 and Option 3 in paragraphs 5.64 to 5.69 of the Consultation Paper, and we support the principle that disclosure should be compelled only of those cash-settled equity derivative transactions that capture a real and direct interest in the shares as opposed to a purely economic interest in the *price* of the shares. Such a real and direct interest might (if it actually existed) be set out in the terms governing the derivative transaction or (more likely) under a side arrangement, agreement or understanding; and might relate either to the exercise of voting rights attached to the shares or to the acquisition of the shares during, at the end of or after the term of the derivative or to both voting rights and acquisition of the shares.

Consultation response

Rather than attempting to address each question in the Consultation Paper one by one (most if not all of the questions being addressed, we believe, either expressly or implicitly in our comments in this letter), we thought it would be most helpful to focus on what we perceive to be the principal issues arising out of the Consultation Paper.

Key issues arising in relation to Option 2

First, we focus on the principal issues in relation to Option 2.

1. Scope of transactions covered. It is clearly important for market participants to know with as much certainty as possible whether any specific transaction is disclosable under the current regime or falls within any safe harbour implemented along the lines proposed. We understand that the principal focus of the Consultation paper is on CFDs and that you are concerned to capture other types of transactions, such as equity swaps, with a comparable economic effect, namely, giving one of the parties a long economic exposure to movements in the price of specified shares.

   Nonetheless, in our view, the scope of transactions caught by the proposed rules is too wide at present. We would suggest a more "principles-based" definition that would be sufficiently broad to address the policy concerns, give the FSA sufficient flexibility to address attempts to avoid the rules and yet provide clearer guidance and certainty to the market as to what is in and what is outside the new regime. To this end, assuming FSA does take further steps, we would be happy to work with you further to articulate a more precise definition of "comparable financial instrument" to achieve this goal.

2. Scope of market participants covered. We believe that derivatives dealers acting as writers of CFDs (or as sellers of share price exposure under comparable transactions) should be clearly exempt from the disclosure requirements in relation to their hedge positions. The current exemptions for market makers are limited and require resources to cover the related monitoring.

   In the Consultation Paper you note that the Code Committee of the Takeover Panel chose to create an exemption for recognised intermediaries acting in a client-serving capacity in relation to its own disclosure rules for equity derivatives.

   We believe, however, that a different set of criteria would be needed for this status in a more general disclosure regime than is currently the case under the Takeover Code. The Takeover Panel effectively requires, among other things, that a recognised intermediary be a market-maker in the underlying shares. As a result, some significant equity derivatives dealers with substantial operations do not qualify for this status, yet there is no good policy basis for excluding them.

   We note that in paragraphs 5.77 and 5.78 of the Consultation Paper you come to the view that there is no need for a general "recognised intermediary" exemption in relation to Option 2 or Option 3, but we respectfully disagree and would be pleased to discuss this with you in more detail. We would also be happy to work with you on the detail of an appropriate recognised intermediary exemption.

3. Proposed wording for and scope of safe harbour.

   We have prepared, and attach to this letter, a draft of a sample contractual provision to be incorporated into an equity derivative transaction documented under an ISDA Master Agreement. This language is intended to meet the requirements of the safe harbour set out in proposed DTR 5.3.1R (2), subject to the following comments:

   (a) We believe that it is important the safe harbour rule itself, and wording intended to comply with it, be no broader than is necessary to achieve goal of "flushing out" formal or informal agreements and understanding relating to voting or hedge share purchase. There are situations where a share is subject to a corporate event such as a merger or takeover. These are dealt with in ISDA's standard documentation for equity derivatives transactions, in particular, in our 2002 ISDA Equity Derivatives Definitions and our standard form Master Confirmation Agreements for equity derivatives. Under these provisions, the Calculation Agent may be required in certain circumstances to exercise its discretion in various ways in order to make a commercially reasonable adjustment to the terms of the derivative, reflecting the impact of the relevant corporate event on the underlying share. The safe harbour wording should not prevent or restrict the Calculation Agent from consulting the long party as to its commercial expectations in such instances, provided always that there is timely disclosure of any agreement or understanding between the parties effectively permits the long party to influence voting or to acquire hedge shares from the short party.

(b) We strongly urge you to drop the requirement in sub-clause (c) of DTR 5.3.1R (2) from the safe harbour requirement. We do not see that it is necessary, if the parties have represented that there is no agreement as to voting or hedge share purchase and the party long the share exposure has agreed that it will not attempt to influence voting or seek access to the hedge shares without disclosing. Intention is subjective and variable, and a provision seeking to regulate it would be extremely difficult to enforce.

Furthermore, the long party's intentions could change during the course of a CFD or comparable transaction for perfectly legitimate reasons. Unless the long party makes an arrangement, enters into an agreement or reaches an understanding with the short party regarding voting rights or hedge share purchase, its intention cannot effectively be policed but is also of no effect.

(c) We suggest that in the wording of DTR 5.3.1R (2) it would be preferable to use terms such as "equity performance payer" and "equity performance receiver" rather than the terms "provider" and "holder", which may be appropriate for CFDs but are less appropriate for other types of equity derivative transactions intended to fall within the regime.

(d) Finally, the FSA should make clear in its final rules that Option 2 would have no retrospective application to existing transactions and that such transactions would not be subject to the disclosure regime. We understand that this is, in fact, your intention, but we would be grateful if you could confirm this.

Key issues arising in relation to Option 3

There are a number of reasons why we object to Option 3. Among others, we highlight the following:

1. There is no compelling evidence that there is systematic use of CFDs to influence voting or obtain access to shares. The FSA appears to reach the same conclusion in the Consultation Paper, and we endorse that view.

2. There is no reason in principle why equity derivatives transactions under which a party has a purely economic exposure should be disclosed. This would address no valid policy concern and could reduce the willingness of market participants to use equity derivatives, affecting their own risk management efforts and market liquidity more generally.

3. Excessive disclosure of equity derivative positions would potentially cause more harm than good, generating information that could be misleading as to the real sources of influence on the shares and that would be difficult to process, evaluate and use.

4. As the Consultation Paper indicates, the cost implications of Option 3 would be considerable relative to Option 2, although we note that Option 2 would also have cost implications and these would not be negligible. We understand that other respondents to the Consultation Paper may be providing more detail to the FSA on this point, although it is difficult to assess the full cost implication until the precise detail has been settled and a system-build plan has been developed and its likely cost worked out by each institution in order to accommodate the new regime. To that extent, our members doubt the statement in paragraph 5.66 of the Consultation Paper that the costs of Option 2 would be minimal. We do, though, agree with the statement in that paragraph that Option 3 would "risk … more far-reaching negative market effects". Although comparisons may be made with the disclosure regime promulgated by the Takeover Panel, it should be remembered that the FSA's proposed rules would apply to a much wider range of stocks.

Nonetheless, if the FSA ultimately concluded that it should adopt some form of Option 3, we would be happy to work with the FSA to ensure that the new rules were, as far as possible, workable. As to the need for clarity as to the scope of transactions covered, our comments in relation to Option 2 apply with equal or greater force to Option 3. As to scope of market participants covered, it seems to us that in relation to Option 3 a "recognised intermediary" exemption would be critical to ensuring that the regime is not disproportionately costly and that it does not lead to excessive and confusing or potentially misleading disclosures.

Other issues

Our summary of the issues arising out of the Consultation Paper is not, of course, exhaustive, and we are aware of other responses being submitted raising comparable and related concerns. But we would like to highlight three further areas of concern regarding the proposals in the Consultation Paper:

1. First, we believe it is important to avoid duplicate and overlapping disclosure requirements. To that end, we applaud the proposal to confirm that disclosure under the Takeover Code would obviate the need for a separate disclosure.

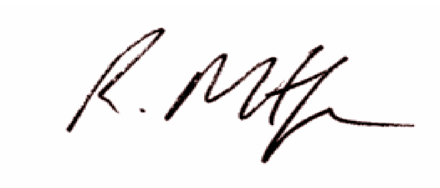
2. Secondly, we are deeply concerned about potential abuse by issuers or their agents of the power to issue frequent and sometimes duplicative notices under section 793 of the Companies Act 2006. To that end, while we are pleased to see that the FSA has taken account of this concern in its discussion of this provision in paragraphs 5.35 to 5.39 of the Consultation Paper, we do not believe the proposed rules go far enough to curb potentially frivolous and vexatious issuer requests. Although the safeguards described in paragraphs 5.38 and 5.39 of the Consultation Paper are an important first step in this area and must make it through to the final rules promulgated by the FSA, our members strongly believe that further safeguards are necessary. We would be happy to work with the FSA to elaborate these points further.

3. Finally, many of our members have stressed that if either Option 2 or Option 3 is chosen, with whatever modifications, there will be considerable operational implications and a significant lead time will be necessary to ensure compliance. Indeed, some of our members have mentioned system-build times of as long as two years. We respectfully request that the FSA take this into account when deciding when any new regime should come into effect after it has been announced.

Once again, we thank you for the opportunity to comment on the Consultation Paper. We hope the foregoing has been helpful, and we look forward to working with you further in coming up with a solution that benefits the market without imposing undue burdens on it. We support maximum clarity as to the basis on which the market operates. What we cannot condone is the indiscriminate generation of reports that serve no genuine informational purpose.

We would be happy to speak with you further regarding the issues raised above or any other matter relating to the Consultation Paper. You will note that, in relation to certain key issues, we have suggested that further detailed work be done. We would urge the FSA to have a further consultation on any detailed rules dealing with the issues raised in the current Consultation Paper, before such rules are implemented. If you have any questions you wish to raise or comments you wish to discuss in relation to this, please do not hesitate to contact Richard Metcalfe (rmetcalfe@isda.org; (020) 3088 3552).

Yours sincerely,



Richard Metcalfe
Senior Regulatory Advisor

ANNEX

Provisions to be incorporated by reference[2] in the Confirmation of an equity swap, contract for difference (CFD) or other "comparable financial instrument", including any cash-settled option (providing, in effect, a long position on the economic performance of shares), to satisfy the requirements of proposed Rule 5.31R, set out in Annex B under the heading "Option 2" in Appendix 1 to Consultation Paper 07/20 issued by the UK Financial Services Authority entitled "Disclosure of Contracts for Difference: Consultation and draft Handbook text".

In addition, and without prejudice, to Section 13.2 of the Definitions,[3] each party makes the representations, agreements and acknowledgments applicable to such party below in relation to each Transaction to which this [ ] 2008 Supplement to the Definitions is applicable:

(i) each party represents that there is no oral or written arrangement, agreement or understanding between them that will entitle the party with a net long economic exposure to any Shares (the "Equity Performance Receiver") to, or to have the right to, purchase or otherwise acquire any Shares to which the other party (the "Equity Performance Payer") has access as a Hedge Position for that net long economic exposure; and

(ii) the following agreements are made by the Equity Performance Receiver:

(a) the Equity Performance Receiver (I) is precluded from directing or otherwise exerting any influence over, whether directly or indirectly, any voting rights attaching to the Shares to which the Equity Performance Payer may have access at any time during the term of this Transaction as a Hedge Position for the Transaction and (II) shall not make any directions or give any instructions seeking to exert such influence to the Equity Performance Payer, any Affiliate of the Equity Performance Payer or any officer, director, employee, agent or representative of the Equity Performance Payer or such Affiliate, unless the circumstances described in (b)(I) below apply and provided that, in such case, the Equity Performance Payer has made any required disclosure under any law, rule or regulation referred to in (b) below; and

(b) if the Equity Performance Receiver and the Equity Performance Payer, or any Affiliate of the Equity Performance Payer, enter into any oral or written arrangement, agreement or understanding that the Equity Performance Receiver will, or will have the right to, (I) direct or otherwise exert influence over any voting rights attaching to the Shares to which the Equity Performance Payer may have access at any time during the term of this Transaction as a Hedge Position for the Transaction or (II) purchase or otherwise acquire any Shares to which the Equity Performance Payer has access as a Hedge Position, then the Equity Performance Receiver will, immediately upon entering into such arrangement, agreement or understanding, make the disclosure it is required to make in respect of such Shares under any applicable law, rule or regulation.

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[2] These provisions could be set out in a Supplement to the 2002 ISDA Equity Derivatives Definitions or in a Master Confirmation Agreement and therefore incorporated by reference or otherwise set out in full in a Confirmation for each relevant Transaction.

[3] This assumes "Agreement and Acknowledgment Regarding Hedging Activities" is applicable to the Transaction.