

**30 May 2014**

## **ESMA Consultation Paper: Draft Regulatory Technical Standards on major shareholdings and indicative list of financial instruments subject to notification requirements under the revised Transparency Directive**

### **Introduction**

On behalf of their members, AFME and ISDA welcome the opportunity to comment on the ESMA consultation paper on draft regulatory technical standards on major shareholdings and the indicative list of financial instruments subject to notification requirements under the revised Transparency Directive.

We welcomed some positive developments of the revised Transparency Directive, such as the aggregation principle, which provides the ability to include in the notifications the breakdown by the type of financial instrument (i.e. distinction between cash-settled and physically-settled derivatives).

The exemptions from notifications for market making activities (under Article 9.5) and trading books (under Article 9.6) are also positive developments.

We are keen to engage in a constructive dialogue with ESMA and with national regulators on the implementation of the Transparency Directive.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

ISDA is listed on the EU register of interest representatives, registration number 466-43241096-93.

## ANNEX 1: CONSULTATION QUESTIONS & RESPONSES

### **Aggregation**

**Q1: Do you agree that the trading book and the market maker holdings should be subject to the same regulatory treatment regarding Article 9(6b)?**

We note in respect of the calculation of the 5% notification threshold applicable to (i) acquisitions or disposals of shares by a *market maker* in its capacity as a market maker and (ii) voting rights held by a credit institution or investment firm in its *trading book*, including in the case of a group, that ESMA concludes that the formal differences between market making and trading book do not justify different regulatory approaches to the market making and the trading book exemptions and that the RTS should follow a common approach for the two exemptions (although noting that the requirements for the two exemptions are not identical, in that Article 6 of the Commission Directive sets out control mechanisms specific to market makers). As a result, ESMA considers that a credit institution or an investment firm applying for the trading book and the market making exemption should comply with the same organisational requirements.

We agree that positions in the trading book and the market making book should be calculated in the same way for purposes of Article 9(6b). The relevant activities have similar organisational requirements, which allow respective firms to assess holdings in each category in the same way.

We also support that non-EU entities are able to use these exemptions.

In addition, we would welcome a confirmation that under the trading book exemption the first disclosure threshold that applies to holdings exceeding 5% is 10% or the next disclosure threshold after 5% for jurisdictions that apply thresholds between 5% and 10%.

**Q2: If not, please identify reasons and provide quantitative evidence for treating trading book and market making holdings differently?**

Please see answer to Q1.

### **Horizontal aggregation**

**Q3: Do you agree with the ESMA proposal of aggregating voting rights held directly or indirectly under Articles 9 and 10 with the number of voting rights relating to financial instruments held under Article 13 for the purposes of calculation of the threshold referred to in Article 9(5) and (6)? If not, please state your reasons.**

We broadly agree with the proposal of measuring the aggregate voting rights under Articles 9, 10, 13 against the thresholds stipulated under Articles 9(5) and 9(6) in order to determine whether any disclosure obligation exists.

However, for the purposes of the breakdown to be included in the form of notification, we believe that the following two categories should be applied: (i) voting rights under Articles 9 and 10 and (ii) financial instruments under Article 13(1). This is because it can be difficult in practice to distinguish between holdings under Article 9 and holdings under Article 10.

***Q4: Can you estimate the marginal cost of changing your general major shareholding disclosure system for the purposes of notification of trading book and market making holdings, i.e., having different buckets for the purposes of the exemptions? Please distinguish between one-off costs and on-going costs.***

Many of our members already have systems which can deal with differing disclosure requirements of different Member States. Changes in such systems can be complex and costly, but ongoing costs may be lowered as harmonisation is approached.

### ***Vertical Aggregation***

***Q5: Do you agree that, in the case of a group of companies, notification of market making and trading book holdings should be made at group level, with all holdings of that group being aggregated (Article 3(1))?***

ESMA proposes that holdings are aggregated at group level for the purposes of the calculation of the 5% threshold and considers that the concept of group is sufficiently clear with the reference, in Articles 10(e) and 12 of the TD, to "parent undertaking" and "controlled undertaking".

We broadly agree with this and support aggregation at group level, provided that an exemption will apply if an entity within the group which is an asset manager, investment firm or credit institution satisfying the independence criteria under para. 72 (Option 2) of the Consultation Paper (subject to our comments below).

***Q6: Do you agree that an exemption to notify at group level can apply if an entity meets the independence criteria set out under paragraph 72 (Option 2)?***

We support Option 2 rather than Option 1. In principle, we agree that the notion of control should be the basis of the proposed regime for aggregation/disaggregation of group holdings and support the view that, provided controlled undertakings can demonstrate that they operate independently from their parent company, they should benefit from the exemption. In the draft RTS ESMA proposes that the parent undertaking of a credit institution or investment firm wishing to benefit from the exemption in relation to holdings should ensure, among other things, that: (a) the credit institution or investment firm exercises those voting rights that are not related to the shares held in connection with the trading book and market making activities independently of the parent undertaking; and (b) it sends a declaration as to its status to the competent authority of the home Member State of the issuer of the relevant shares.

We also support the requirements for the content of the declaration, i.e. a list of the controlled entities with their competent authorities and a statement that these controlled entities do not receive any direct or indirect instructions from the parent undertaking in the exercise of the voting rights.

In addition, we understand that the exemption applies to non-EU groups and non-EU controlled undertakings where it can be demonstrated that the relevant undertaking's market making and trading activities as well as its asset management activities meet the independence criteria on an ongoing basis as set out in the draft RTS.

However, rather than sending the declaration to the competent authority of the Member State of the issuer, we suggest adopting an approach in line with that for notifications for the market making exemption under the Short Selling Regulation. Under this approach, a parent undertaking which has a home Member State would send the declaration to its own competent authority, which could then notify ESMA that it has received such notification from the parent undertaking. A parent

undertaking which is a third country entity would send its notification to the competent authority of the main trading venue in the European Union in which it trades. ESMA could then publish and maintain on its website a list of all parent undertakings that have given such notifications. This would efficiently centralise all notifications relating to the same group and avoid the need for multiple notifications to competent authorities in Member States.

We support ESMA's view that the parent undertaking of the group and the credit institution or investment firm should establish written policies and procedures reasonably designed to prevent the distribution of information between the parent undertaking and the credit institution or investment firm in relation to the exercise of voting rights.

***Q7: Please provide an estimate on how many times a year would your group have to report a major disclosure under the current regime in comparison to Option 1. Please include an estimate of the one-off or on-going costs involved.***

Generally Option 1 would require more reporting than the current regime requires since there is currently no requirement to aggregate cash-settled instruments which are economically equivalent to physical shares, although some Member States have implemented this. However, the costs associated with such increase in reporting are difficult to quantify.

***Q8: Do you think that Option 2 poses any further enforceability issues than Option 1? If yes, what kind of issues can you foresee arising out of it? Can you propose an alternative approach?***

Since regulators already monitor the risk levels and compliance of trading desks with related policies and articulated risk limits, regulators should be equipped to oversee and enforce the disclosure regime. In addition, the approach proposed in response to Q6 above would make the market, regulators and ESMA aware of entities making use of the exemption thereby enhancing transparency. There should be no significant enforcement difficulties posed by Option 2 when compared with Option 1.

### ***Method of calculating the number of voting rights referred to in Article 13(1a)(a) in the case of financial instruments referenced to a basket of shares or an index***

***Q9: Do you agree with the proposal that financial instruments referenced to a basket or index will be subject to notification requirements laid down in Article 13(1a)(a) when the relevant securities represent 1 % or more of voting rights in the underlying issuer or 20 % or more of the value of the securities in the basket/index or both of the above?***

Although we understand the rationale behind the 1% and 20% thresholds and believe that they would be helpful in reducing the number of disclosures which would not be meaningful to the market, whilst reducing scope for abuse, we also believe that a requirement to aggregate basket or index transactions at those levels could be burdensome and that such thresholds would be difficult and costly to monitor. Therefore we request that ESMA consider increasing the thresholds.

With regard to the 1% threshold, in the case of certain commonly used market indices the notional value of the index is calculated by using the value of 100% of the issued shares of each component issuer (i.e. the total market value of the shares of each issuer) so that technically such indices would always breach the 1% threshold if they were calculated by reference to the number of shares of an issuer contained in the index. It would therefore be helpful to clarify in Article 4(1)(a) of the draft RTS that the 1% threshold is calculated by reference to the number of shares represented by the financial instrument rather than the number of shares contained in the basket or index itself.

In addition, we believe that it would also reduce the cost and burden of monitoring such transactions, and the incidence of meaningless disclosures, to include one or more of the following clarifications:

- (i) that if an index/basket is re-balanced or adjusted on a regular basis either automatically or at the discretion of a third party then passive breaches of the thresholds need not trigger a requirement to aggregate the transaction;
- (ii) that if the composition of an index/basket is determined by a third party and the investor in such index/basket has no power to influence the composition, the investor should not need to aggregate the transaction referencing such index/basket;
- (iii) that the index/basket weights will only be observed on the trade date at the outset and not continuously tested; and
- (iv) that the thresholds should apply such that aggregation is required only if both of them are breached.

Regarding point (i) in particular, we note that in the UK the FCA has given guidance to the effect that passive changes due to index re-balancing do not require additional disclosure.

***Q10: Are there any other thresholds we should consider?***

We have no specific proposals to make.

***Q11: Please estimate the number of disclosures you would have to make per year should the above mentioned thresholds be adopted. Please also provide an estimate of the compliance costs associated with the disclosure (please distinguish between one-off and on-going costs).***

AFME and ISDA do not have specific information as this will vary considerably amongst member firms.

***Q12: Do you agree that a financial instrument referenced to a series of baskets which are under the thresholds individually but would exceed the thresholds if added and totalled should not be disclosed on an aggregated basis?***

Yes, we agree. Our view is that aggregating baskets would add complexity that could compromise firms' ability to monitor effectively but would not achieve a significant benefit to the market.

As an example of the potential complexity, we note that any requirement to aggregate a series of baskets could be interpreted as applying to any one of the following situations, among others:

- (i) multiple trades on the same basket; or
- (ii) multiple trades on similar baskets (which all contain a particular stock); or
- (iii) multiple iterations of the same/similar trade with different customers, or some/all of the trades with the same customer.

In addition, we request clarification that Article 4(2) of the draft RTS applies to indices and not only baskets. The draft wording currently refers only to baskets, however, since paragraph 2 is a derogation from paragraph 1, we believe it should refer to both indices and baskets as paragraph 1 does.

## ***Methods of determining delta for the purposes of calculating voting rights relating to financial instruments which provide exclusively for a cash settlement***

***Q13: Do you agree that our proposal for the method of determining delta will prevent circumvention of notification rules and excessive disclosure of positions? If not, please explain.***

Yes, we fully agree that the Option 1 is not feasible as it might not be a practicable solution. We strongly agree that the Option 2 is an efficient way to specify the method of determining delta.

We consider that a principles-based approach will allow a regulated entity to use the calculation method which it has already agreed with its regulator in the contexts of risks and pricing. The resulting integrity of calculation will avoid unnecessary costs and confusion on the part of disclosers and regulators. Regulators will be able to assess the usefulness of the principles-based calculation on an ongoing basis.

***Q14: Do you agree with the proposed concept of "generally accepted standard pricing model"?***

Yes. In general we very strongly support the principles-based approach and the requirement to use a generally accepted standard pricing model (e.g. Black-Scholes). This would ensure meaningful information across the EU for the sake of appropriate transparency for regulators and market participants. It would ensure that firms and their clients are able to report appropriately.

## ***Draft regulatory technical standard on client-serving transactions***

***Q15: Are these three types of client serving exemptions all appropriate in terms of avoiding excessive or meaningless disclosures to the market? Please provide quantitative evidence on the additional costs borne by financial intermediaries should any of these ex-emptions not be adopted.***

Yes.

The examples are appropriate, but some clarification is necessary regarding the use of the word "proprietary". The phrase "otherwise than on a proprietary basis" should be clarified to mean "otherwise than for the client-serving entity's own investment purposes". In other words, such transactions are not initiated by the regulated firm as an investment of own funds for its own profit, even if the firm enters into the relevant transaction as principal.

***Q16: Can these three types of client-serving exemption allow for a potential risk of circumvention of major shareholdings' disclosure regime?***

In our view the potential risk of circumvention, whether for purposes of controlling or influencing an issuer's board or a shareholder vote or for any other reason, would be minimal, since such risk would be largely offset by the disincentive of countervailing risks to the investor and/or intermediary, including in particular the economic risk of an unhedged short position (mentioned in para. 118) and the regime prohibiting market abuse. We agree with the conclusion reached in para. 121, i.e. that it is highly unlikely that a financial intermediary would enter into such transactions to avoid disclosure given the possible costs and risks.

***Q17: Do you agree with our analysis that applying the current exemptions can address certain notification requirements for cash-settled financial instruments introduced by Article 13(1)(b)?***

We agree with your conclusion that the current exemptions can address certain of the notification requirements for cash-settled instruments introduced by Article 13(1)(b). Please see response to Q18 below in relation to further relevant scenarios.

We believe that the transactions set out in paras. 115 to 117 constitute market making, although the Transparency Directive market making exemption has not been uniformly implemented across Member States and therefore cannot be relied upon in relation to all transactions which are of a client-serving nature.

***Q18: In your opinion, is the application of current exemptions sufficient to achieve the aim of this provision (i.e. avoiding unmeaningful notifications to the market)?***

We strongly believe that the current exemptions are not sufficient to achieve the aim of this provision and that the introduction of a client-serving exemption would be advisable and beneficial to the market in order to avoid a large number of unmeaningful or confusing disclosures.

The inclusion of certain cash-settled financial instruments under Article 13.1.(b) fundamentally changed the objective of the TD from only identifying significant voting interests (which can directly influence issuers) to also identifying significant economic exposures. The separate addition of this specific component to the TD regime requires that Article 13.4 be interpreted as introducing a separate and specific client-serving exemption, as opposed to simply overlaying the pre-existing market making and trading book exemptions, which are otherwise applicable only to shares or instruments giving a right to acquire shares (TD 2004 Articles 9 and 13.1).

Any cash-settled positions that are entered into for purely client-serving purposes would, if they were disclosed, mask direct positions entered into for investment purposes and thereby undermine the overriding objective of accurate transparency. This is because client-serving transactions consist of fulfilling orders received from clients, responding to a client's requests to trade otherwise than on a proprietary basis, or hedging positions arising out of such dealings, as set out in paras. 114-117.

In addition, AFME and ISDA members strongly believe that the exemption should apply to any financial instrument (including physical shares and physically settled derivatives) that a client-serving entity holds in order to hedge a cash-settled derivative transaction entered into in a client-serving capacity. As drafted, the proposed exemption seems intended to apply only to long cash-settled derivative positions which a firm holds in this capacity. However, just as it would not provide meaningful information to the market if a client-serving entity were to disclose a long derivative position it has entered into at a client's request (Case 2, para. 116), equally it would not provide meaningful information to the market if a client-serving entity were to disclose a long position in shares which it holds as a hedge to a short cash-settled derivative position it has entered into at a client's request (Case 3, para 117). In both cases the financial intermediary would, absent an appropriate exemption, have a disclosable long position as a direct result of its activity as a client intermediary – indeed, we presume that by highlighting Case 3, ESMA agrees that the exemption should apply equally in this scenario as in Case 2. Provided that the client-serving entity does not intend to and does not in practice vote any shares it holds as a hedge in this client-serving capacity, that physical shareholding held as a hedge should be exempt from disclosure because it does not provide the market with meaningful information.

With the inclusion of certain cash-settled instruments, the 5% thresholds for both the market making and trading book exemptions could be reached too easily, but not in a meaningful way, thereby resulting in excess information to the market which could obscure the identity of true stakeholders. Moreover, the effectiveness of the current market making exemption is limited in that the application of the rules can vary substantially across Member States. In certain Member States the application of the rules can be overly cumbersome and to that extent may not be utilised as intended in those Member States.

Therefore, we believe that in order to avoid duplicative and unmeaningful disclosures in the market and to promote meaningful and accurate transparency, a separate, harmonised and effective

client-serving exemption is required and that this should also apply to physical positions which hedge a client-serving transaction.

***Q19: Do you agree that the client-serving exemption should cover MiFID authorised entities as well as a natural or legal person who is not itself MiFID authorised but is in the same group as a MiFID authorised entity and is additionally authorised by its home non-EU state regulator to perform investment services related to client-serving transactions? Can you foresee any additional cost in case the exemption does not also cover non-EU entities within the group? If yes, please provide an estimate?***

We agree that the client-serving exemption should extend to both MiFID authorised entities and non-MiFID authorised entities which are in the same group as a MiFID authorised entity. Many firms are likely to have in their group entities which engage in client-serving activities but which are not MiFID authorised.

For example, one relevant scenario may be where, in response to a client order, a note issuance vehicle issues structured securities, which would constitute financial instruments for the purposes of Article 13(1). The arrangement for such transactions could be that the securities are bought by a "dealer", who would in turn sell them to the client. Therefore it could be the dealer, rather than the issuer, which faces the end client and is MiFID authorised for that client-facing role. We do not believe it is within the intention of the TD for the issuer to have to report its hedge position since that would be duplicative of the end client's disclosure under Article 13, since the holding would be to hedge a client-serving transaction (being the issuance of the note). Therefore such a vehicle should not need to be responding to its own client's requests in order to use the exemption. We consider that the exemption should be adjusted to reflect that the "client" for the purposes of the client-serving exemption could be a client of an affiliate.

The non-MiFID authorised firms would incur additional costs of compliance if the exemption were not to extend to them.

In addition, we note that the drafting of Q19 conflates non-MiFID authorised entities with non-EU entities and that this is not consistent with the TD, since not all exemptions contained in Articles 9(4), (5) and (6) require MiFID authorisation. Where an exemption under the TD is aimed at MiFID authorised firms, it specifically says so, as in the market making exemption under Article 9(5), whereas the custody exemption under Article 9(4) does not require MiFID authorisation. The language of Article 13(4) refers to "a natural person or a legal entity", accordingly we take the view that the client-serving exemption should be construed as applying to non-MiFID entities, whether EU or non-EU, so long as they are in the same group as a MiFID-authorised entity.

***Q20: Do you think that the proposed methods of controlling client-serving activities are effective? Do you envisage other control mechanisms which could be appropriate for financial intermediaries who wish to make use of the exemption?***

We take the view that the notification that these entities have to make in order to rely on the exemption should be sent to their home Member State regulator rather than to the Member State of the issuer. A third country entity should send the notification to the competent authority of the main trading venue in which it trades within the European Union rather than to the Member State of the issuer. The Member State regulator receiving such notification should then coordinate with the other regulators of the relevant issuers or ESMA accordingly.

***Q21: When does a financial instrument have an "economic effect similar" to that of shares or entitlements to acquire shares? Do you agree with ESMA's description of possible cases?***



The inclusion of repurchase and stock lending agreements in the list has the effect that routine stock lending or repo operations by investors would trigger notifications, since a shareholder's long position would change from a physical holding of shares to a financial instrument (being the right of recall of the shares under the stock loan or repo agreement), whereas a stock loan or repo operates as a disposal with a simultaneous agreement to re-acquire the shares at a later date. This would lead to a large volume of disclosures of a technical nature reflecting routine stock lending or repo activity where there is no change in the underlying economic exposure. In addition, we recommend that it should be clarified that stock loan and repo transactions are not included in limb (g) of Article 13(1b). This is in line with the position in the UK, where rule 5.1.1(5) of the FCA's Disclosure and Transparency Rules specifies that a stock-lending agreement which provides for the outright transfer of securities and which provides the lender with a right to call for re-delivery of the lent stock (or its equivalent) is not to be taken as a disposal by the lender of any shares that are the subject of the stock loan.

***Q22: Do you think that any other financial instrument should be added to the list? Please provide the reasoning behind your position.***

We do not suggest that further instruments be added to the list.