New FSA Regime for Disclosure of Contracts for Difference

London
November 5, 2008

The UK Financial Services Authority ("FSA") has published a "Feedback and policy statement"[1] setting out the new general disclosure regime for long contracts for difference ("CfD") positions and other cash settled instruments which is designed to address concerns in relation to voting rights and corporate influence. In summary, from September 1, 2009, existing share and CfD holdings in the same listed company must be aggregated for disclosure purposes. The initial disclosure threshold will be at 3% in line with the existing disclosure rules applicable to shares. The FSA is proposing an exemption for CfD writers which act as intermediaries, similar to the Takeover Panel's Recognised Intermediary exemption, to reduce unnecessary disclosures.

Background

In November 2007, the FSA issued a consultation paper[2] in which a number of failings in the current major shareholder disclosure regime were highlighted. The current disclosure regime for major shareholdings in listed companies is set out in the DTR sourcebook of the FSA Handbook[3], more specifically DTR 5. These rules derive from the Transparency Directive and are referenced to direct and indirect control of voting rights attaching to a share, requiring disclosure to the issuer and the FSA above certain thresholds. They also require[4] disclosure of entitlements to acquire voting rights resulting from holding financial instruments, including transferable securities and options, futures, swaps, forward rate agreements and any other derivative contract referred to in Section C of Annex 1 of the Markets in Financial Instruments Directive ("MiFID"). However, under the current rules, although physically settled call options have to be disclosed to the market, CfD generally fall outside the scope of the DTRs. The only two exceptions are where the CfD: (i) explicitly gives a right to acquire the underlying shares; or (ii) gives access to the voting rights attached to underlying shares which are held as a hedge by the CfD writer.

[1] http://www.fsa.gov.uk/pubs/cp/cp08_17.pdf

[2] http://www.fsa.gov.uk/pages/Library/Policy/CP/2007/07_20.shtml

[3] http://fsahandbook.info/FSA/html/handbook/DTR

[4] DTR 5.3.2.

In their November 2007 consultation paper, the FSA indicated that CfD were being used to circumvent the current disclosure regime for shares. The FSA highlighted that market participants were entering into CfD in order to influence voting and build stakes in the underlying companies without having to disclose their position to the issuer and the FSA. Accordingly the FSA felt that such activities were distorting the market for takeovers, giving inefficient price information regarding the underlying shares and diminishing market confidence.

The November 2007 consultation paper proposed three potential options to address these issues:

1. Option 1: leave the current disclosure regime as it stands. The FSA rejected this option without proceeding with consultation;

2. Option 2: implement a targeted disclosure regime with additional issuer request powers. Under this option, all CfD would be disclosed unless a 'safe harbour' was applicable, such as an express term of the CfD stating that the CfD holder could not influence voting rights attaching to applicable shares or have access to the shares upon maturity. To supplement the 'safe harbour' regime, issuers would have request powers to further ascertain the identity of CfD holders. The FSA consulted on this option but eventually rejected it on the basis that it would be too difficult to operate and enforce; or

3. Option 3: a general disclosure regime requiring all CfD to be subject to the same rules as shares. After consultation the FSA confirmed that they would be adopting this option to formulate their new policy.

New Policy

As a result of the consultation process, the FSA have decided to extend the scope of the existing DTR categories of shares and qualifying instruments by also requiring disclosure of "any financial instruments having similar economic effect to a qualifying financial instrument". This will be the case if its terms are referenced, in whole or in part, to an issuer's shares and, generally, the holder of the financial instrument has, in effect, a long position on the economic performance of the shares, whether the instrument is settled physically in shares or in cash. Only gross long positions are within the scope of the proposed rules.

The proposed rules will apply to instruments referenced to shares of UK incorporated issuers that, as set out in DTR 5.1.1, are traded on regulated or prescribed markets. Companies incorporated outside of the UK will be subject to the equivalent regime in their home member state and those rules should be considered separately.

The relevant threshold for disclosure will be 3% and above. Although the Transparency Directive includes different thresholds at 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%, when implementing the Transparency Directive in the UK, HM Treasury and the FSA decided to retain the previous Companies Act 1985 thresholds of 3% and above for companies incorporated in the UK. The FSA have decided therefore that the new policy for disclosing CfD should mirror the regime for shares and that CfD positions and shares should be aggregated to calculate whether the 3% or above threshold is reached.

The FSA are also proposing to include an exemption in the new regime available for CfD writers, authorized by its Home State under MiFID or the Banking Consolidation Directive to deal as principal, which shall operate in a similar manner to the Takeover Panel's disclosure exemption for desks of banks and securities houses which have Recognised Intermediary status and which act in a client-serving capacity. Therefore where CfD writers are effectively acting as intermediaries and providing liquidity, for example where a CfD writer writes a short CfD for a client and effectively takes a long position itself, disclosure would not be required. The important distinction made by the FSA is between acting in a client-serving capacity and proprietary business. Further examples of the former which are given by the FSA are CfD positions taken as a result of filling a client order or which are taken out to facilitate or hedge a client order. An example of the latter which would require disclosure is the taking of a CfD position in anticipation of future client orders. A firm wishing to take advantage of the exemption would be required to notify the FSA every 12 months with a certification that it satisfies the conditions and complies with ongoing obligations set out in the rules. As a pre-condition for the exemption, the firm will be required to certify that it considers itself able to qualify for client-serving intermediary status.

The two existing exemptions from the major shareholder reporting requirements, the market maker exemption and the trading book exemption, have also been considered by the FSA. The market maker exemption is only available for market making activity in shares and therefore will not be available for holders of CfD. The trading book exemption however, will be available for holders of CfD provided that the CfD are held on the trading book. Stock held as a hedge can benefit from the trading book exemption, up to the limit of 5%.

For the purposes of making disclosures of CfD positions post-September 1, 2009, the FSA have indicated that the process currently applicable for shares will be adopted for CfD: the holder of the CfD will need to notify the issuer and the FSA within two days using the prescribed TR-1 form. The FSA have produced a draft revised TR-1 form (attached as an appendix to the October 2008 feedback and policy statement) for the purposes of making the notification.

The FSA are now satisfied that the draft policy they have circulated is in final form although they are continuing to consult on 'technical' aspects until January 23, 2009 with the aim of finalizing the rulebook in February 2009. The new rules will come into effect on September 1, 2009.

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