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News Bulletin

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UK Contracts for Difference Disclosure Regime

On 27 February 2009, following the issue of its consultation paper (CP 08/17)[1] on the disclosure of Contracts for Difference ("CFDs"),[2] the UK Financial Services Authority ("FSA") published the Disclosure and Transparency Rules (Disclosure of Contracts for Differences) Instrument 2009[3] (the "New Rules"). With effect from 1 June 2009, the New Rules will amend Chapter 5 of the UK's Disclosure and Transparency Rules ("DTR"). The effect of the New Rules is to require, for the first time, the disclosure of pure economic interests in the shares of listed UK companies.

Amendments to the Disclosure and Transparency Rules

At present, Chapter 5 of the DTR requires disclosure by a person who holds either (a) shares, or (b) qualifying financial instruments, in each case providing control of at least 3% (in the case of a UK issuer) or at least 5% (in the case of a non-UK issuer) of the total voting rights in respect of an issuer whose shares are admitted to trading on a regulated market or a UK prescribed market.

Qualifying "*financial instruments*" are defined in DTR 5.3.2R as transferable securities and options, futures, swaps, forward rate agreements and any other derivative contracts which result in an entitlement of the instrument holder to acquire, under a binding agreement, shares to which such voting rights are attached.

The New Rules preserve the existing disclosure obligations and the definition of financial instruments. However, in addition to financial instruments as defined above, the disclosure obligation will now also arise in respect of the following instruments (unless the client-serving intermediary exception applies, as discussed later):

> *financial instruments…which…(i) are referenced to the shares of an issuer, other than a non-UK issuer; and (ii) have similar economic effects to (but which are not) qualifying financial instruments within DTR 5.3.2R*

As to what instruments have "*similar economic effects*" in this regard, some guidance is provided by the new DTR 5.3.3G(2), which states:

> *(a) a financial instrument has a similar economic effect to a qualifying financial instrument…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. This is because such an instrument may give the holder the potential to gain an economic advantage in acquiring, or gaining access to, the underlying*

[1] http://www.fsa.gov.uk/pubs/cp/cp08_17.pdf.
[2] Financial instruments which: (i) are referenced to the shares of an issuer, other than a non-UK issuer; and (ii) have similar economic effects to (but which are not) qualifying financial instruments within DTR 5.3.2R.
[3] http://fsahandbook.info/FSA/handbook/LI/2009/2009_13.pdf.

shares. For example, that result may occur because of the likelihood that the counterparty will have hedged with the underlying shares or with an instrument which may provide access to such shares. The holder may then be in a more advantageous position, compared to other market users (i.e., other potential purchasers of the shares), to gain access to those shares, either directly from the counterparty, or indirectly, for example in the market following sale by the counterparty…

The effect of this addition is therefore to require disclosure by the holder of not only contracts for differences, as traditionally understood in a UK context, but also other cash-settled equity derivative contracts which derive their value by referencing shares of a UK-incorporated and UK-listed company, if the holding references shares with 3% or more of the total voting rights in the issuer's shares.

In the consultation period leading up to the publication of the New Rules, many respondents had expressed concern as to exactly how disclosure of certain cash-settled derivative positions would be made, particularly cash-settled call options on single shares, and cash-settled derivative positions on share indices or share baskets, and DTR 5.3.3G(2) now provides the following guidance:

(b) "long" derivative financial instruments not having a linear, symmetric pay-off profile in line with the underlying share (that is, instruments not having a "delta 1" profile, for example cash-settled options) should be considered to have an economic effect in relation to the underlying shares represented, similar to that of a qualifying financial instrument, only in the proportion which is equal to the delta of the instrument at any particular point in time. So, for an instrument with a delta of 0.5 on a particular day, the instrument will provide a "similar economic effect" in half of the underlying shares represented. This will mean that holders may need to monitor delta changes at the end of each trading day in order to determine whether a disclosure is required;

(c) a financial instrument referenced to a basket or index of shares will not have similar economic effects to a qualifying financial instrument unless: (i) the shares in the basket represent 1% or more of the class in issue and 20% or more of the value of the securities in the basket or index; and (ii) use of the financial instrument is connected to the avoidance of notification…

Accordingly, where financial instruments with a similar economic effect to (but which are not) financial instruments for the purpose of DTR 5.3.2R, the person making the relevant notification, will eventually have to disclose on a delta-adjusted basis. This is because the requirement to make disclosure on a nominal basis could lead to the disclosure of high nominal amounts which may mislead the market. However, in order to allow more time for those making such notifications to adapt to the new requirements, the FSA will allow reporting on either a nominal or delta-adjusted basis for a period of seven months from 1 June 2009. Should the choice be made to report on a nominal basis, however, the FSA will also require sufficient additional information (such as the strike or exercise price of each financial instrument being reported, as well as the total number of voting rights relating to shares referenced by each such instrument) to allow market participants to calculate their underlying exposure more accurately. After 31 December 2009, all reporting will take place on a delta-adjusted basis.

Client-Serving Intermediaries

Similar to the "financial intermediary" exemption to the UK's Takeover Code, the New Rules provide for an exemption from disclosure for contracts for a client-serving intermediary which is acting in a client-serving capacity and which satisfies the following conditions:

(a) it is authorised by its home state regulator, or as a third-country investment firm (a firm that would be a MiFID investment firm if it had its head office in the EEA), to deal as principal, in a client-serving capacity, in such financial instruments, and to carry on any relevant business connected to such dealing; and

(b) it has appropriate systems and controls in order to identify, distinguish between and monitor its client-serving dealings and interests and its proprietary trading dealing and interests; and

(c) when acting in a client-serving capacity, it:

(I) is not able to, nor does it attempt to, intervene in; and

(II) does not exert, or purport to exert, influence on,

the management of the issuer concerned; and

(d) acting through a person of at least director level, it has certified in writing to the FSA, within the last 12 months, that it considers itself to qualify for client-serving intermediary status and that it satisfies the conditions in (a) to (c), and if it is not a MiFID[4] or BCD[5] authorised firm, then another member of its group which is so authorised must give the same certification.

A client-serving intermediary must inform the FSA as soon as it becomes aware that it no longer satisfies the above conditions and provide the FSA, on request, with information relevant to its status or operation as a client-serving intermediary.

A client-serving intermediary is considered to be acting in a client-serving capacity if it is fulfilling client orders, responding to a client's requests to trade, or hedging positions arising out of either type of dealings, in each case on a non-proprietary basis.

Finally, it is also worth noting that the other current exemptions from disclosure in DTR 5.1.3, (including the market-maker exemption from disclosure of shareholdings representing up to 10% of the voting rights, and the exemption from shares held within a firm's trading book, representing up to 5% of the voting rights) shall be available for CFDs in the same way that they are for shares.

Notification

Notification of an interest in CFDs shall be made as soon as possible, but not later than four trading days, in the case of a non-UK issuer, and two trading days in all other cases, after the relevant person learns (or should have learned) or is informed about the acquisition or disposal. Such notification must be made on a Revised TR-1 Form that is attached as Appendix 2 to the New Rules.[6] It shall also be made on an aggregated basis with notifications in respect of physical holdings of shares.

An issuer must make public all of the information in the notification as soon as possible and in any event by not later than: (a) the end of the trading day following the receipt of the notification, in the case of a UK issuer whose shares are listed on a regulated market; or (b) in all other cases, the end of the third trading day following receipt of the notification.

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[4] Markets in Financial Instruments Directive 2004/39/EC.
[5] Banking Consolidation Directive 2000/12/EC.
[6] http://www.fsa.gov.uk/pubs/cp/cp08_17.pdf.

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