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# Heightened Derivatives and Trading Disclosure for UK Equity Markets

Regulatory initiatives to increase disclosure have become quite commonplace. Such initiatives occasionally to unnoticed these days. Yet, two recent UK developments are worthy of note for anyone with an economic interest in shares listed on a UK regulated or prescribed market, including the London Stock Exchange's Main Market, AIM and PLUS, as they impose new mandatory disclosure obligations. The first relates to contracts for difference in respect of any share listed on a UK regulated or prescribed market, whereas the second relates to short-selling of such shares only in the context of a rights issue.

## Disclosure of CFDs

On 2nd July 2008, following a lengthy consultation period, the UK Financial Services Authority (FSA) announced its updated policy and proposed rules on the disclosure of contracts for difference (CFDs), aimed at increasing transparency as to holdings of derivatives positions that can be misused for the purposes of obtaining significant holdings or voting rights in publicly listed companies without disclosure.

For this purpose, CFDs are cash-settled derivative contracts or instruments related to the performance of shares listed on a regulated or prescribed market in the UK, and which create for the holder of the CFD a similar economic effect to ownership of the actual shares themselves (a "long position"). By themselves, CFDs confer no rights to acquire the underlying shares, nor to control the voting rights of those shares, and as a result do not currently require public disclosure under the UK's Disclosure and Transparency Rules ("DTR"). However, concerns have existed for some time as to the possible abuse of these instruments, such as the use of explicit or implicit ancillary arrangements whereby the writer of the CFD (who may often hold the underlying shares itself to hedge its CFD obligations) would agree to sell the underlying shares to the holder of the CFD in the future, or to exercise the voting rights on those shares in accordance with the wishes of the CFD holder.

In its original consultation paper in November 2007, the FSA invited feedback from interested parties on three alternative approaches advanced in the paper.

Option 1 (the "change nothing" approach) was generally accepted to be a non-starter. Option 2 (involving disclosure of CFDs unless they meet certain safe harbour requirements), although favoured by some groups, such as derivatives dealers, did not receive much overall support during the consultation process.

Ultimately, it is the blanket disclosure regime under "option 3" which the FSA has decided to adopt, with a few modifications as to the disclosure threshold and aggregation and an exemption to be drafted for CFD writers acting as intermediaries.

The proposed new rules will, therefore, oblige the holder of a long position under a CFD to disclose its interest to the UK listed company where the referenced shares reach or exceed 3% of its total issued shares. This is in line with the existing threshold under DTR for physical holdings, but in future the DTR will aggregate such long CFD position with physical share holdings. Aggregation was deemed necessary not only to prevent a 'loophole' which would have allowed an investor to build up a covert stake of up to 8% through a combination of shares and CFDs, but also to avoid a costly parallel disclosure regime. These new rules will bring the DTR much more in line with the disclosure obligations imposed by the UK Takeover Code in respect of CFDs written on shares subject to a takeover offer.

Similar to the UK Takeover Panel's 'recognised intermediary' exemption, CFD writers will be exempted from disclosure where they are only acting as intermediaries and providing liquidity, though the wording for this exemption has yet to be proposed and will be eagerly awaited by derivatives dealers.

The obligation to disclose long CFD positions will apply to all holders of CFDs in companies listed on a UK regulated or prescribed market, once their aggregate holding reaches or exceeds the relevant threshold, regardless of where the holders are located.

The FSA will be publishing a detailed Feedback Statement in September 2008 together with the draft rules, on which technical and drafting comments will be invited, with a view to publishing final rules in February 2009. The new rules are intended to come into force by no later than September 2009.

## Short-selling disclosure

On 13th June 2008 the FSA published the Short Selling Instrument 2008[1], which came into force on 20th June 2008 and amended the UK's Code of Market Conduct to require disclosure of certain types of short-selling.

This instrument was highly unusual for two reasons. Firstly, it imposed share-related disclosure obligations on parties who hold neither the shares, nor a long position of any description. Secondly, it was not preceded by any warning or consultation period, taking the market by surprise.

This Instrument was brought in by the FSA as an emergency method of stabilizing the market in the shares of UK-listed companies, particularly banks and building societies, currently undergoing rights issues. The FSA is concerned that short-selling of such shares, whilst not in itself an abusive practice, creates opportunities for certain parties to engage in market abuse (such as circulating rumours intended to drive the share price lower), and therefore concluded that the market needs to be aware of which parties are engaging in short selling in the context of a rights issue.

Under the new rules, as clarified by the FSA's Frequently Asked Questions 20th June 2008 Update ("FAQ")[2], a holder of a "disclosable short position" (i.e., a short position representing an economic interest of 0.25% or more of the issued capital of a company whose shares are admitted to trading on a UK prescribed market) during a rights issue period, must make a public disclosure of its position in the prescribed manner. Failure to make "adequate disclosure" will render the short-selling a "market abuse" under FSMA, either as "misleading behaviour" under section 118(8)(a) of the Financial Services and Markets Act 2000 ("FSMA") or as a "distortion" under section 118(8)(b) of FSMA.

For this purpose, an 'economic interest' includes any instrument which gives the holder "an exposure, whether direct or indirect, to the shares" of the company (excluding shares held in a market maker capacity). Therefore, the disclosure obligation covers short positions under options and other derivative instruments referencing the shares as well as shorting the shares themselves.

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[1] http://fsahandbook.info/FSA/handbook/LI/2008/2008_30.pdf

[2] http://www.fsa.gov.uk/pubs/other/Shortselling_faqs.pdf

For the disclosure to be adequate, it must be made by means of an announcement, through an FSA-approved Regulatory Information Service (RIS), by 3.30pm (London time) on the business day following the date on which a disclosable short position is obtained and must include the name of the holder, details of its disclosable short position and the name of the issuer of the shares.

Similarly to the obligation to disclose long CFD positions, the new short-selling disclosure regime applies to any holder of a short position in a UK listed company during its rights issue period, once the holder's exposure reaches or exceeds the disclosable threshold, regardless of where the holder is located.

These provisions have caused some agitation in the UK market and many participants feel that they were not adequately considered before being implemented. They may turn out to be temporary, as the FSA has announced that they will be kept under review and that further measures may be introduced, such as restrictions on lending stock subject to a rights issue and on short sellers covering their short positions by acquiring rights to the rights issue shares. The FSA is likely to have regard to similar restrictions imposed by regulators in other jurisdictions, in crafting its longer term policy on short-selling in the context of rights issues.

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We will continue to provide updates on any further guidance received from the FSA and other related developments concerning disclosure of CFD positions or short-selling.

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