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LEARNING CURVE®

U.K. Contracts For Difference Disclosure Regime

The U.K. Financial Services Authority has announced that it will soon require the disclosure of cash-settled contracts for difference on U.K.-listed equities. The policy would for the first time extend the current shareholding disclosure regime to CFDs under which the holder has no rights to require physical delivery of the underlying shares or to control voting of those shares.

In the new regime, which is expected to be in place no later than September next year, CFDs are cash-settled derivative positions which provide exposure to movements in the price of a share listed on a regulated exchange or a prescribed exchange in the U.K. The description also therefore potentially includes equity swaps, options and forwards, as well as securities and other structured products linked to such shares.

The Rules

The Disclosure and Transparency Rules, which implement the EU Transparency Directive in the U.K., already require the holders of such positions to disclose their interests above certain thresholds— starting at 3% of the listed company's shares—where such positions entitle the holder to require physical delivery of the underlying shares. But where such a derivative position is cash-settled, and is not combined with any agreement by which the holder has a right to acquire the underlying shares or control the voting rights attached to those shares, the Rules do not require their disclosure.

This position is in contrast with the U.K. Takeover Code which requires that once a company subject to the Code is in an offer period, a person holding an interest of 1% or more of any class of relevant securities of such company must publicly disclose all its dealings in any relevant securities. The Code specifically provides that a long derivatives position shall be considered an interest for this purpose.

Implementation

Since the Transparency Directive is a minimum harmonization directive, the FSA is empowered to implement rules in the U.K. which are more stringent than those in the Directive, and it has already done so by providing for lower disclosure thresholds for U.K. companies than those prescribed by the Directive.

At the time of implementing the Rules last year, the FSA noted that there was no consensus in the market on whether disclosure should be extended to pure cash-settled positions, and such disclosure was not required by the Transparency Directive. But, prompted by the concerns over the non-disclosure of such cash-settled derivative positions of certain market participants, particularly issuers and investors in their shares, the FSA agreed to carry out further analysis to establish whether there was a justification for so-called gold-plating the provisions of the Directive in this way.

The concerns of these participants relate primarily to a lack of transparency of CFDs, possibly giving rise to price distortion in the shares, as well as providing opportunity for abuse. Such abuse could arise by virtue of holders of long derivatives positions being in a position to influence the voting of the actual shares by exerting pressure on the holders of the corresponding short position.

The counter-argument put forward by other market participants, particularly the writers of and investors in such CFDs, is that requirements for disclosure of CFDs would lead to dissemination of excessive amounts of information and that this would end up hindering transparency, rather than promoting it. This is because the information could appear duplicative, or even contradictory, and therefore damage liquidity in CFDs. It might also harm liquidity in the shares themselves, since holders of shares might limit their holdings to avoid disclosure thresholds and in addition there would be lower demand for the physical shares from CFD writers to hedge their CFD exposure.

The FSA's Options

Of the three possible options suggested by the FSA in its Consultation Paper, Option 1, which required no change to the existing regime, was almost entirely discounted by the FSA. Option 2 sought to strike a balance between the two opposing views on disclosure. This option provided that a CFD needed to be disclosed if it referenced 3% or more, aggregated with any physical positions, of the total shares of the U.K.-listed company unless the CFD fell within certain safe harbor provisions. This included the contractual wording of the CFD stating that the holder of the long position had a genuine intention not to hold the underlying shares and that the holder had no rights to exert any influence over the voting of the shares. However, it also allowed the share issuer to make a request for disclosure to a person it reasonably believed to have a long CFD position on at least 5% of the issuer's shares.

The FSA reported that during the consultation period, it received little support for this Option 2—despite the forceful representations of the **International Swaps and Derivatives Association** on behalf of CFD writers and their clients—and much more support for a solution along the lines of its Option 3—a blanket disclosure obligation on holders of long CFD positions above a certain threshold.

The policy finally adopted by the FSA is to require the holders of long CFD positions in a U.K.-listed company to aggregate these positions with any holdings that they have in the same shares, and to disclose details of their interests where the aggregated position consists of, or references, 3% or more of the shares in a U.K. incorporated company—or 5% or more of the shares in a non-U.K. incorporated company. The FSA's stated reasons for proposing such aggregation were, firstly, so that it would not be possible for combined shareholdings and CFD "stakes" in excess of 3% to be built up without disclosure, by keeping the holder just under the disclosure thresholds for both instruments and, secondly, so that there would not be potentially costly parallel disclosure regimes for physical and CFD positions.

However, the FSA accepted the argument that there should be an exception from this disclosure regime for CFD writers acting in the capacity of intermediaries on the basis that adding a disclosure burden to such entities would not provide useful information. For instance, where a dealer writes a short CFD position for a client, it could be said to have taken on a long CFD position, but to require it to disclose would not increase transparency as to corporate control. Therefore, the FSA will draft an exemption for CFD writers, similar in effect to the recognised intermediary exemption that exists under the U.K.'s Takeover Code. ISDA has already announced that it will start work immediately on its proposed wording for the intermediary exemption in relation to CFDs.

What's Next

The next step is for the FSA to publish its Policy Statement in September, together with a Feedback Statement detailing the responses received during the consultation period and the draft rules necessary to effect the policy. These rules are expected to take the form of an amendment to the Disclosure and Transparency Rules.

A consultation period will follow, in which technical comments on the draft rules will be accepted, with final rules to be published in February 2009. A further implementation period will then follow, to allow all participants to implement any necessary changes to their systems and procedures before the new rules become fully operational, no later than September 2009.

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*This week's Learning Curve was written by **Jeremy Jennings-Mares** and **Peter Green**, partners with **Morrison & Foerster** in London.*
