Recent developments in the disclosure regime for economic interest in shares

by Peter Green and Jeremy Jennings-Mares, Morrison & Foerster (UK) LLP

Most jurisdictions impose obligations requiring the disclosure by holders of shares in companies, particularly listed companies where such holding is above a specified threshold. The definition of what constitutes a holding of shares for this purpose varies between jurisdictions. There has, however, been considerable focus recently on whether such disclosure requirements should extend to pure economic interests in shares where the 'holder' does not physically hold the shares or have the ability to control the voting rights attaching to the shares. Most jurisdictions do not currently require the disclosure of such pure economic interests, but the increasing use of equity derivatives has resulted in this issue being put in the spotlight. The issue has most recently been addressed in the UK with the Financial Services Authority (FSA) announcing that it will introduce new rules applying the disclosure regime to most derivatives (referred to as contracts for difference (CFDs) in the FSA papers) that give a party a long economic exposure to shares in UK companies admitted to trading on a regulated market or a prescribed market (including the AIM).

Rationale for requiring disclosure of economic interests in shares

The rationale behind requiring shareholders to disclose material shareholdings in a company is generally to provide transparency to companies, enabling them to monitor who has a significant holding in the shares. Disclosure of such interests helps to limit the scope for parties to conceal major shareholdings in companies and engage in market manipulation, and other forms of market abuse.

The recent FSA initiative referred to above focuses on CFDs that give the holder an economic benefit from increases in the underlying share price. Such transactions can include options, futures and swaps over shares and can be in respect of a single share, an index or a basket of shares or indices. Where the transaction is purely cash settled, no physical transfer is made of the shares underlying the CFD but a payment is made from one party to the other based on movements in the underlying share price. For example, in a total return swap relating to a share, one party (the

total return receiver) will receive from the other party (the total return payer) an amount equal to all dividends paid on the relevant shares during the period of the swap, plus an amount equal to the increase in the market value of the shares during such period. In return, the total return receiver receives notional interest payments plus an amount equal to the decrease in the market value of the shares during the same period. The total return receiver is therefore placed in the same economic position as if he had acquired the relevant shares, but as there is no actual transfer of shares, transaction costs (including stamp duty) that would normally be incurred on a physical transfer of shares can be avoided.

Many CFD transactions are entered into for purely economic and hedging purposes. Increasingly, however, such arrangements are also used by parties seeking to exert influence over the company's board of directors and for the purpose of synthetic stake building in the company. Even if the CFD does not provide for the counterparty to receive physical shares, the nature of the arrangements are likely to result in changes in the market value of the share being reflected in corresponding changes to the mark to market value of the swap. Therefore, the swap counterparty could in theory seek to unwind the swap and utilise the proceeds in acquiring the relevant underlying shares. The FSA concluded in their consultation paper that CFDs have been used by certain market participants to exert influence and/or build up stakes in companies on an undisclosed basis.

The current position in the EU, UK and elsewhere

The principal European legislation in relation to the disclosure of interests in shares is contained in the Transparency Directive (Directive 224/109/EC of the European Parliament and of the Council of December 15, 2004). Under Article 9 of the Directive, each Member State shall ensure that shareholders notify the relevant issuer (where the shares of the issuer are admitted to trading on a regulated market) of the percentage shareholding it holds in the issuer where such percentage reaches, exceeds or falls below certain specified thresholds (5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%). Such disclosure only applies to voting shares in the issuer.

Under Article 10 of the Transparency Directive, the notification provisions outlined above are also applied to any person who has the right under an agreement or collateral arrangements to exercise the relevant voting rights or to direct the holder of the shares as to how to exercise such rights. This provision would, therefore, only apply to CFDs entered into in respect of the shares if the CFD gave the counterparty the right to direct voting rights over the shares, or granted such party collateral over the shares provided under the collateral arrangements. Such party would control the voting rights and declare its intention of exercising them. The Transparency Directive contains various exemptions relating to shares which are held by recognised market makers and to holdings by investment firms or credit institutions not exceeding 5%. These are held in their trading book provided that the voting rights are not used to intervene in the management of the issuer.

Peter Green

Jeremy Jennings-Mares

Peter Green, Partner
Capital Markets Practice
tel: +44 (20) 7920 4013
e-mail: pgreen@mofo.com

Jeremy Jennings-Mares, Partner
Capital Markets Practice
tel: +44 (20) 7920 4072
e-mail: jjenningsmares@mofo.com

Most cash settled CFDs in relation to shares do not give the counterparty to the transaction the right to vote or influence the voting rights of the shares subject to them. These would therefore fall outside the scope of the Transparency Directive. The Directive is however a 'minimum harmonisation directive', meaning that member states can enact additional provisions requiring more onerous disclosure obligations.

Currently in the UK, the Disclosure and Transparency Rules adopted by the FSA largely follow the approach set out in the Transparency Directive. However, they impose additional threshold notification requirements in relation to shares in companies incorporated in the UK and admitted to trading on a regulated or prescribed market. In relation to such entities, disclosure is required each time the percentage shareholding goes to or above, or falls below, 3% (and each 1% above such figure). Under these rules, disclosure is required where the interest is acquired under a 'qualifying financial instrument'. In addition to transferable securities, this definition includes options, futures, swaps, forward rate and any other derivative contracts in respect of such securities. They are only included, however, if they result in an entitlement to acquire, on the holder's initiative, under a formal agreement, shares to which voting rights attach. As with the Transparency Directive, such provisions should therefore not currently apply to most cash settled CFDs. The UK rules also apply to shares in non-UK issuers incorporated in an EEA state listed on a regulated market which have the UK as its home Member State. This is for the purpose of the Transparency Directive

and to certain non-EEA issuers whose shares are listed on a UK regulated market.

Under these rules, the relevant party must make the relevant notification electronically, on a prescribed form, within two trading days of the relevant threshold being triggered. The period is extended to four trading days in the case of a non-UK issuer.

In the UK, disclosure of pure economic positions in shares can, however, be required under the Takeover Code (the "Code"). Under the Code, where a company is subject to a takeover offer, persons interested in 1% or more of the company must publicly disclose their dealings in any relevant securities of that company. A person is specified to be interested in such securities if it has a long economic exposure in the shares, including by way of a derivative transaction, a transaction that is entirely cash settled. Parties are, however, generally permitted to disregard any derivative referenced to a basket or index of relevant securities if they represent less than 1% of the securities in issue and less than 20% of the basket.

Most other EU member states have adopted the provisions of the Transparency Directive without including additional provisions requiring disclosure of purely economic interests in shares obtained through CFDs. Some other jurisdictions do, however, require disclosure of such interests. For example, in 2007, Switzerland introduced rules requiring disclosure of certain holdings in cash settled derivatives.

The issue also came into focus in a recent court case in the US. It was held that the British based hedge fund group, The Children's Investment Fund (TCI) had failed, pursuant to Section 13(d) of the Securities Exchange Act, to disclose an interest exceeding 5% which the court determined it had built up in the US railroad company CSX. TCI's interest had been acquired through it entering into a cash settled total return equity swap relating to the shares in CSX. Under Section 13(d), disclosure is required where a person beneficially owns more than 5% of a public company. On the facts, it was held that there was sufficient evidence that TCI had the power to influence the decision of the swap counterparty to purchase CSI shares and to vote those shares in a manner beneficial to TCI. Therefore, the court did not find it necessary to rule as to whether the entry into of an equity derivative, giving a synthetic long position in the shares, resulted in a beneficial ownership of the shares for the purpose of Section 13(d). Interestingly, the Securities Exchange Commission (SEC) submitted a letter to the court stating that, except in unusual circumstances, it does not consider interests under a total return swap to constitute beneficial ownership in the securities underlying the swap.

Recent developments in the UK

In November 2007, the FSA published a consultation paper setting out three possible alternative approaches in relation to extending the share disclosure regime to economic interests obtained through CFDs. In addition to maintaining the status quo where such interests are not subject to disclosure, the FSA invited responses on a proposal for a 'blanket disclosure' of such interests above a certain threshold, and a 'halfway house' which would have provided for disclosure of CFD positions, unless they fell within certain safe harbour positions. This latter approach would have exempted disclosure of transactions where the counterparty is precluded from exerting any influence over voting rights over the relevant shares.

Following the consultation process, the FSA announced in July 2008 that it would proceed with an approach largely based on the blanket disclosure proposals. Its proposed new disclosure regime will require the aggregation of CFD positions with actual holdings of shares for the purpose of the disclosure thresholds, which otherwise remain unchanged. The FSA have, however, stated that there will be certain exemptions for derivative dealers acting as intermediaries. The FSA is expected to publish its final policy statement in September 2008. This will provide the draft rules necessary to implement the policy including the derivative dealer exemption. It is expected that the final rules will be published in February 2009 and become fully operational no later than September 2009.

There is a divergence of views in relation to the FSA's stated policies. Many derivative dealers and hedge

funds have expressed the concern that the majority of derivatives relating to shares are not entered into from a desire to obtain corporate control, exert pressure on the board or acquire an economic stake in companies while avoiding the disclosure requirements. Concerns include the possibility that, in relation to transactions entered into for purely economic purposes, the new disclosure regime will impose an additional administrative burden and increase transaction costs.

It is also not entirely clear that additional disclosures required by the new regime will necessarily provide issuers with valuable information. Although in some cases, it will enable companies to detect economic stake building in the company that may be used as a precursor to a take-over offer, it is likely that much of the additional disclosure will not be particularly helpful. Indeed, processing the additional information may serve only as a further distraction to an already over burdened company's administration. It is also likely to be difficult for companies to distinguish between parties which are pure economic investors and those which are conducting a stake building exercise. It is also possible in theory for there to be a disclosure of positions in excess of 100% of the share capital of the company making it difficult for the company to obtain a clear indication as to the ownership position in relation to its shares.

The new disclosure rules will initially create an uneven playing field in the UK as opposed to the Transparency Directive and other European jurisdictions. However, in the call for evidence published by the Committee of European Securities Regulators (CESR) in relation to possible level 3 work (work on guidance notes and coordinating the implementation of the Transparency Directive in Member States) on the Transparency Directive in July 2007, it mentioned the application of the notifications regime to stock lending and derivative products as a possible area to be addressed through level 3 work. In its feedback statement in February 2008, this area was specified as one in which market participants indicated to CESR could be addressed in this way.

It remains to be seen whether further proposals in this area come from CESR or other European jurisdictions. With regard to the interest and visibility that the debate in relation to the FSA's proposed new rules in the UK has generated, it seems very likely that this item will remain high on the agenda of further work in relation to the Transparency Directive, and see a levelling of the playing field again. Bearing in mind the increased use of derivatives to obtain economic interests in companies, it seems very likely that there will be movement in this direction.

Contact us:
Morrison & Foerster (UK) LLP
City Point, One Ropemaker Street
London EC2Y 9AW, UK
tel: +44 (20) 7920 4000
fax: +44 (20) 7496 8500
web: www.mofo.com
e-mail: london@mofo.com