L E A R N I N G C U R V E®

U.K. Contracts For Difference Disclosure Regime

*The disclosure of derivatives being used in takeover situations has garnered much attention of late with **Porsche**'s winning options strategy in trading **Volkswagen** options. This Learning Curve focuses on some of the challenges with deciphering new rules proposed by the U.K. **Financial Services Authority**.*

The question of the need for disclosure of cash-settled equity derivatives has recently been very much in the public eye (albeit in Germany, rather than the U.K.) following the statement by Porsche that it had silently built up cash-settled options referencing over 30% of the shares in Volkswagen. This statement subsequently led to such a large VW share price increase that it left VW temporarily as the world's largest company by capitalisation and caused many raised eyebrows that such a large economic interest could be amassed without triggering the need for disclosure.

In the U.K., Rule 8.3 of the Takeover Code would prevent a Porsche/VW situation arising in the course of an offer period, without prompt public disclosure. But the position outside an offer period has, until now, been less clear.

The FSA recently published its Consultation Paper (CP 08/17) on the Disclosure of Contracts for Difference, as foreshadowed by its July 2008 policy statement (see DW Online, 7/21). The Consultation Paper sets out the draft Disclosure and Transparency Rules (Disclosure of Contracts for Differences) Instrument 2009, which amends Chapter 5 of the U.K.'s Disclosure and Transparency Rules.

At present, Chapter 5 of the DTR requires the 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 U.K. issuer) or at least 5% (in the case of a non-U.K. issuer) of the total voting rights in respect of an issuer whose shares are admitted to trading on a regulated market or a U.K. 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 draft changes to Chapter 5 DTR will preserve the existing disclosure obligations and the definition of qualifying financial instruments. However, in addition to qualifying financial instruments, the disclosure obligation will 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-U.K. issuer; and
> (ii) have similar economic effects to…qualifying financial instruments within DTR 5.3.2R."

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

> "(i) 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."

The effect of this addition is, therefore, to require disclosure by the holder of not only contracts for differences, as traditionally understood in a U.K. context, but also other cash-settled equity derivative contracts which derive their value by referencing shares of a U.K.-incorporated and U.K.-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 draft new U.K. rules, many respondents 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. The proposed DTR 5.3.3G(2) provides the following guidance:

- "i) '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 disclosed on a delta adjusted basis. In other words, such instruments would, in general, be considered to have an economic effect...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.

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- ii) a financial instrument referencing a basket or index of shares will not have similar economic effects to a qualifying financial instrument unless 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.

In a similar way to the financial intermediary exemption to the U.K.'s Takeover Code, the above provisions regarding disclosure of contracts for differences expressly do not apply to a client-servicing intermediary that is acting in a client-serving capacity and which satisfies the following conditions:

a) it is authorised by its home state regulator 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 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 Markets in Financial Instruments Directive or Banking Consolidation Directive-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. 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 otherwise than on a proprietary basis.

Although the consultation process leading up to the FSA's publication of the draft rules has addressed several concerns and questions raised in the process, some technical questions still remain, including how certain provisions of the existing and the new rules will operate together. Some examples include the interaction between the new client-serving intermediary exemption and other existing exemptions from disclosure in DTR 5.1.3. These include the "market-maker" exemption from disclosure of shareholdings representing up to 10% of the voting rights, and the exemption for shares held within a firm's trading book, representing up to 5% of the voting rights.

These issues should hopefully become clearer over the next couple of months. The FSA has invited technical, but not policy, comments on the draft rules to be received by Jan. 23, with the aim of the rules being finalised in February and coming into force in September.

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

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