Disclosure of CfDs – concerns for corporate issuers

SLAUGHTER AND MAY
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DISCLOSURE OF CFDS — CONCERNS FOR CORPORATE ISSUERS

1. Introduction

On 15 November 2007 the FSA issued a consultation paper on additional disclosure obligations relating to economic interests in listed shares held through derivatives such as contracts for difference (CFDs).

CFDs fall outside the current disclosure framework as the Disclosure and Transparency Rules (DTRs) reference direct and indirect control of voting rights and the investigative regime under CA 2006 s793 generally does not apply to derivatives. However, since 2005, the Takeover Code has required disclosure during an offer period of dealings by holders of economic interests in 1% or more of the securities of a target company.

The FSA reports that issuers and investors have raised concerns regarding the lack of general disclosure of holdings of CFDs. It has concluded that there have been some specific ‘failures’ of the current regime and that additional measures should be adopted to cover CFDs. The FSA has put forward two options to meet this objective – further details of each option are set out below.

This paper examines the FSA’s proposals from the standpoint of corporate issuers, questions whether either option would adequately address the failings of the current regime and sets out the case for an alternative approach.

2. The failings of the current regime

The CFD market in the UK has grown significantly in the last five years. Between 20% and 40% of turnover in the cash equities market is now thought to be driven by activity in related derivative products, including CFDs. However, these products fall outside the scope of the DTRs and CA 2006 s793 unless they explicitly give access to voting rights attached to underlying shares or to the shares themselves on expiry of the contract.

It is arguable that this technical distinction for disclosure purposes does not bear close scrutiny in the context of the practical operation of the market. CFD writers will usually hedge some or all of their positions with underlying shares. Whilst it may be the stated policy of these institutions not to close out a CFD by selling the underlying shares to the holder and not to accept voting instructions from a holder on how to vote underlying shares, it is accepted that both of these things happen in certain circumstances. As the Takeover Panel stated when consulting on its 2005 rule changes “it is frequently the expectation of a holder of a long CFD that the counterparty will ensure the shares to which the CFD is referenced are available to be voted by the counterparty and/or sold to the holder of the CFD on closing out of the contract”. Indeed, in relation to the sale of underlying shares, it should be noted that a large equity holding may be difficult to unwind in the short term absent a sale to the CFD holder.
The FSA has identified three broad areas of concern arising from non-disclosure of CFDS, namely: asymmetry of information, exercise of influence on management, and undisclosed stakebuilding. Each of these is likely to be of concern to corporate issuers.

> Asymmetry of information arises because for the duration of a CfD it is only the parties to the CfD that know the holder’s identity, level of interest, intentions and time-horizon. Although CfD writers’ aggregate hedging positions may fall to be disclosed under the DTRs, these disclosures do not enable a judgement to be made as to whether they have been taken for hedging purposes or proprietary investment and therefore do not provide reliable information as to the identity of the real investor.

> It is becoming increasingly common for corporate issuers to be approached by CfD holders who expect to be treated as if they were holders of the underlying shares. Absent any disclosure of the CfD position, corporate issuers are often not able to verify the level of economic interest held or whether the CfD holder has access to voting rights. Given that the majority of these approaches are, to a degree, confrontational, this leaves the corporate issuer in the unenviable position of having to decide whether or not to enter into discussions without knowledge of the CfD holder’s true position. Even if the position is disclosed to the corporate, it can then be faced with a difficult decision whether it should publicly disclose the information that it has been given.

> CfDs can also be used to build up large economic positions prior to a takeover. If the CfD holder has an informal arrangement to take delivery of the underlying shares, or simply knows that it is in a good position to acquire those shares, the DTRs are effectively circumvented. Whilst the insider dealing and market abuse regimes make it difficult for a prospective bidder to conclude that it is able safely to stakebuild in this manner ahead of launching a takeover offer, there remains the potential for a CfD holder to ‘surprise’ a corporate and the market when it acquires the hedge shares when closing out a CfD.

In light of these concerns, it is unsurprising that the FSA has concluded that changes should be made to the current regime. However, the FSA’s analysis of market failure and its assessment of how far to go in addressing that failure seem to concentrate more on the interests of CfD holders and CfD writers (and, in particular, their respective compliance costs) and less on the position of corporate issuers.

3. The FSA Options

The two options put forward by the FSA (having discounted Option 1, namely making no change to the current regime) are as follows:

> **Option 2**: Require disclosure of substantial economic interests unless the holder has taken steps to preclude itself from exercising influence over the underlying shares.

> **Option 3**: Introduce a comprehensive disclosure regime which would require disclosure by all holders of substantial economic interests in shares.
The FSA is consulting on the basis of a clear choice between Options 2 and 3 as it believes that a combination of the two would be of limited value. The consultation closes on 12 February 2008. The FSA aims to implement new rules in September 2008.

It is noticeable that the consultation does not seem to have considered whether CfDs should simply be treated for disclosure purposes as if they were shares. Even though this might be thought of as risking “over disclosure”, it remains surprising given the concerns regarding the operation of Options 2 and 3 discussed below and the approach adopted in the Takeover Code. The case for a wider disclosure regime – identified as Option 4 in this paper – is set out below.

4. Option 2

Under Option 2, CfDs would be deemed to have access to voting rights unless they meet three safe harbour requirements. These are that:

> the relevant agreement explicitly precludes the holder from exercising or seeking to exercise voting rights,

> the relevant agreement excludes further arrangements or understandings relating to the sale of underlying shares, and

> there is an explicit statement by the CfD holder to the CfD writer that it does not intend to acquire or obtain access to the underlying shares held by the CfD writer.

CfDs that do not fall within this safe harbour would be aggregated with other interests in voting rights and the combined total, if above 3%, would be disclosable in line with the current DTRs regime.

There would also be a separate investigative regime under the DTRs, similar to CA 2006 s793, to enable a corporate issuer to ‘flush out’ holders of safe harbour CfDs and other economic interests above 5%. This threshold would operate separately to that for interests in voting rights. A corporate would need to demonstrate that it had had reasonable cause to believe that a person had an economic interest in its shares in order to issue a request (with reasonable cause including an attempt by the person to influence management or significant speculation regarding the interests of the person). Positive responses to requests (i.e., interests above 5%) would fall to be announced by corporate issuers under the DTRs.

The FSA believes that Option 2 represents a ‘targeted and effective’ response to the issues raised by CfDs.

5. Concerns with Option 2

The rationale underlying Option 2 is clear – in circumstances where CfDs are not being used as a stepping stone to the acquisition of underlying shares or to access voting rights they do not give rise to perceived market failures and therefore disclosure is not required.
Whilst perhaps addressing the majority of the failings identified above (although not that relating to asymmetry of information), Option 2 gives rise to a number of concerns:

> The safe harbour requirements are likely quickly to become part of the CfD ‘boilerplate’ with little or no actual thought being given to them by the parties to the CfD.

> A CfD holder could remain within the safe harbour and yet still approach a corporate issuer with a view to exerting influence on management – there is a risk that the threat (real or imagined) of the CfD being used to access underlying shares and/or voting rights would remain.

> In the context of activity that, with the benefit of hindsight, may be viewed as stakebuilding, a CfD holder could also remain within the safe harbour until a change of intention was crystallised (quite possibly due to an external development) – disclosure would only be required at that point and the element of surprise would be preserved.

> The practical question of whether the real intentions of the parties to a CfD could ever be effectively policed by the FSA.

> Option 2 is put forward in the context of a simple CfD holder/writer relationship. The FSA acknowledges that some CfD writers hedge their positions with other CfDs (which may themselves be hedged by third party holdings of underlying shares), but does not consider the consequences of this. For example, the issue of CfD holders influencing holders of hedging shares other than the CfD writer itself is not addressed.

> The FSA’s rationale for setting the threshold for the investigative regime at 5% is consistency with the Transparency Directive (TD). There seems little objective justification for this given the decision to gold plate the TD requirement and the existing CA 2006 investigative regime which facilitates disclosure of any interest in shares.

Whilst Option 2 increases the current disclosure requirements, it should be noted that it would still enable a person to hold significant interests in a corporate issuer without triggering disclosure. It is also possible to suggest ways in which CfD holders might seek to avoid disclosure under Option 2 (such as through the use of CfDs referenced to futures). Although any regime would provide scope for avoidance, the complicated nature of Option 2 would seem to increase the opportunities for this.

However, it seems clear that the FSA currently favours Option 2 and if a wider disclosure regime such as Option 4 is not accepted, the concerns outlined above should be addressed. In particular:

> Safe harbour status should be lost following any direct or indirect attempt by a CfD holder to influence management.

> If the terms of a safe harbour CfD are amended to include arrangements or understandings as regards influence over, or acquisition of, underlying shares thereby resulting in the loss of safe harbour status, the CfD holder and the CfD writer should be obliged to document......
the basis for the amendment with this being disseminated to the market. In these circumstances it should be for the CFD holder and the CFD writer to satisfy the FSA that the initial safe harbour categorisation of the CFD was correct.

> Similarly, following a change of intention on the part of the CFD holder leading to the loss of safe harbour status the CFD holder should be obliged to document the basis for the change with this being disseminated to the market. Again, in these circumstances it should be for the CFD holder to satisfy the FSA that the initial safe harbour categorisation of the CFD was correct.

> The regime should address the issue of hedging through the use of other CFDs leading to underlying shares being held by a party other than the CFD writer.

> The proposed investigative regime should be harmonised with the CA 2006 investigation regime and require disclosure by a holder of any level of safe harbour CFDs or other economic interests in response to a corporate issuer’s request. The obligation on corporate issuers to announce positive responses to requests should, however, be limited (without excluding any general disclosure obligation) to interests in safe harbour of CFDs of 3% or more.

Whilst the FSA’s task is undoubtedly challenging, Option 2 is arguably an over complicated response to the identified concerns that is vulnerable to avoidance techniques that will undoubtedly be investigated by sophisticated market participants. From the standpoint of a corporate issuer, the logical response to this is to consider a wider, but simple regime such as Option 4.

6. Option 3

The FSA states that it has proposed Option 3 in response to the preference of some stakeholders for a general disclosure regime along the lines of that under the Takeover Code. As discussed above, the Takeover Code requires disclosure of dealings during an offer period by holders of economic interests in 1% or more of the securities of a target company.

Under Option 3, there would be a separate general disclosure requirement in relation to all economic interests above 5% which did not provide the holder with the entitlement to acquire underlying shares. There would therefore be two separate categories for disclosure with two separate disclosure thresholds and no aggregation between the two categories.

There would not be a separate investigative regime.

7. Concerns with Option 3

Whilst the FSA’s preference seems to be for Option 2, it refers to a recent survey of 70 UK quoted companies which found that there was 96% support for a disclosure regime based on the Takeover Code. It also refers to a consultation document issued by the Hedge Fund Working Group that recommends the introduction of a general disclosure regime similar to that under the Takeover Code.
Although based on the Takeover Code, Option 3 does not, however, provide the same level of disclosure as the Takeover Code and gives rise to a number of concerns:

> The Takeover Code aggregates all interests in shares for the purposes of disclosure and does not create separate regimes for shares and economic interests.

> The creation of a separate disclosure regime for economic interests and the absence of any investigative regime would seem to ignore the concern that in practice the CfD market may operate so as to facilitate the delivery of underlying shares and/or the control of voting rights thereby blurring the distinction between economic interests and physical holdings.

> The disclosure threshold has been set at 5%, again by reference to the TD. Whilst the FSA states that it wishes to catch only ‘significant’ positions there again seems little objective justification for this given the decision to gold plate the TD requirement in the context of the DTRs bites at 3%.

As with Option 2, Option 3 would still enable a person to hold significant interests in a corporate issuer without triggering disclosure. For example, a 2.9% holding of shares and a 4.9% economic interest held by the same entity would not trigger disclosure. If the FSA wishes to introduce a general disclosure regime along the lines of the Takeover Code then a wider disclosure regime such as Option 4 would be more appropriate.

8. Option 4 – a wider disclosure regime

Given the concerns outlined above, there would seem to be a case for the adoption of a wider disclosure regime. This would apply Takeover Code principle that economic interests in shares such as CfDs should be treated as shares. These interests would therefore be aggregated with interests in voting rights for disclosure purposes and the aggregated total, if above 3%, would be disclosable in line with the current DTRs regime.

There also seems to be a case for introducing an investigative regime along the lines suggested by Option 2 (and subject to the safeguards proposed by the FSA), but harmonising this with the CA 2006 s793 regime to require disclosure by a holder of any level of economic interests in response to a corporate issuer’s request.

The benefits of this wider regime would be:

> transparency for all market participants,

> simplicity – it is straightforward and based on, and in line with, an existing regulatory framework, and

> reduced scope for cynical manipulation of categorisation principles to avoid or delay disclosure.
Market participants are likely to cite increased compliance costs and the possibility of duplicative and confusing disclosures. However, it should be noted that a similar regime operates during offer periods without obvious confusion in the market and therefore compliance functions should already be familiar with the requirements.

9. Conclusion

It is generally accepted that the current regime requires amendment. However, in seeking to balance the interests of all market participants, the FSA seems to have concentrated on limiting the costs of compliance at the expense of producing simple and transparent disclosure proposals that clearly address the failings of the current regime. In particular, the proposals do not seem to address the concerns of corporate issuers regarding the increased use of undisclosed economic holdings to influence management. Whilst Option 2 seems to be preferable to Option 3 in this regard, it does invite avoidance techniques due to its complicated nature.

As stated above, the FSA’s task here is not straightforward, but its proposals do not seem to represent a move towards principles-based regulation. The consultation period provides an opportunity for corporate issuers to encourage the FSA to address the identified concerns in a more appropriate manner, possibly by the introduction of a wider regime such as Option 4.

This paper is not intended to provide legal advice which should be sought on particular matters.
CONTACT ADDRESSES

London
One Bunhill Row
London EC1Y 8YY
United Kingdom
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Paris
130 rue du Faubourg Saint-Honoré
75008 Paris
France
T +33 (0)1 44 05 60 00
F +33 (0)1 44 05 60 60

Brussels
Square de Meeûs 40
1000 Brussels
Belgium
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
47th Floor
Jardine House
One Connaught Place
Central
Hong Kong
T +852 2521 0551
F +852 2845 2125

www.slaughterandmay.com