TRAVERS SMITH

Financial Services and Markets

Countdown to enhanced CFD disclosure

By way of reminder, enhanced disclosure rules for contracts for differences ("CFDs") and similar financial instruments will come into force on **1 June 2009**[1]. Affected persons will therefore need to ensure they are able to meet the requirements in time for this deadline.

This is an updated version of the guidance memo we produced in March. The FSA has now produced its own "Frequently Asked Questions" document, available at: http://www.fsa.gov.uk/pubs/ukla/disclosure.pdf. The FAQs have validated our earlier memo but they have also left open some of the areas of detail we found unclear in the final policy statement. The treatment of rights over unissued shares is a key example where the scope of the regulations has yet to be clarified. We and a number of other market participants have made submissions to the FSA on this topic and we include below the status of our discussions with the FSA.

The new rules will amend Chapter 5 of the FSA's Disclosure Rules and Transparency Rules ("DTR 5").

What does DTR 5 require at the moment - i.e. until 1 June?

In summary, DTR 5 currently requires disclosure of certain interests in voting shares:

- issued by a UK issuer and admitted to trading on a prescribed market (such as AIM); or
- issued by a UK or non-UK issuer and admitted to trading on an EEA regulated market.

The reference point for disclosure under DTR 5 is where a person controls the exercise of voting rights, whether or not he also acquires title to shares. This basic disclosure obligation is extended to apply where a person is entitled to acquire, dispose of or exercise voting rights in specified cases (e.g., where voting rights are temporarily transferred to a person for consideration) or via specific financial instruments resulting in an entitlement to acquire issued shares (e.g., the right to call for delivery of the shares or a physically settled call option).

The disclosure obligations apply to interests of 3% or more of the current issued capital of UK issuers, interests of 5% or more of the current issued capital of non-UK issuers, and as certain thresholds above those levels are reached.

The disclosure obligations do not currently apply to instruments that only give an economic exposure to the underlying shares, such as "vanilla" CFDs (assuming the CFD has no accompanying call option or voting agreement with the counterparty in respect of that counterparty's hedged interest).

Detailed guidance on the current regime is available on request.

What is changing on 1 June?

The new rules will extend the current disclosure obligations to require disclosure of certain economic interests held through CFDs and other financial instruments that:

- are referenced to the voting shares issued by a "UK issuer" and admitted to trading on an EEA regulated market or a prescribed market (such as AIM)[2]; and
- have a "similar economic effect" to (but are not themselves) "qualifying financial instruments".

For purposes of DTR 5, a UK issuer means:

- a body corporate incorporated in and having its principal place of business in the UK; or
- an English, Welsh or Scottish public company.

---

[1] The final rules are available online at: http://fsahandbook.info/FSA/handbook/LI/2009/2009_13.pdf. The FSA's policy statement in relation to the rules is available at: http://www.fsa.gov.uk/pubs/policy/ps09_03.pdf.

[2] AIM companies which are not UK issuers are recommended under the AIM Rules to adopt an equivalent disclosure regime. We understand that Rule 17 will also be amended to reference DTR5 (as amended) - which may give rise to the need to amend constitutions accordingly.

As currently, "qualifying financial instruments" include transferable securities and derivatives under whose terms the holder has, on maturity:

- an unconditional right, exercisable only on his own initiative, to acquire the underlying shares; or
- a discretion as to whether or not he acquires them (i.e. through physical settlement)

What is the disclosure threshold to be for CFDs or similar instruments?

Positions in CFDs or similar instruments must be aggregated with positions in other disclosable instruments and disclosed if the percentage of voting rights attaching to the underlying reference shares reaches, exceeds or falls below 3% and each 1% integer threshold above 3%. As is currently required, percentages should be rounded down to the next whole number.

The disclosure requirement will apply to gross long positions held through CFDs and similar instruments. This means that you cannot net short positions held through CFDs or similar instruments when calculating whether a disclosure threshold is reached or crossed.

What does "similar economic effect" mean?

A financial instrument has a "similar economic effect" to qualifying financial instruments if its holder has a long position on the economic performance of the underlying reference shares. The FSA has adopted a principles-based approach to this, rather than prescribing a list of relevant products. The key point is that the instrument is of a type that may give the holder the potential to gain an economic advantage in acquiring, or gaining access to, the underlying shares. It does not matter for these purposes whether the financial instrument is settled physically or in cash or is traded on- or off-exchange.

Should we calculate our interests on a nominal or delta-adjusted basis?

The new rules require holders of derivative instruments without a "delta 1" profile (such as cash-settled options) to calculate the percentage of voting rights attaching to the underlying reference shares on a delta-adjusted basis (so that, for example, an option with a 0.5 delta on a particular day will have a "similar economic effect" in half of the underlying shares). Holders of these instruments will therefore need to monitor delta changes at the end of each trading day in order to determine whether further disclosures are required.

From 1 June 2009 to 31 December 2009, a transitional provision will allow flexibility for a nominal or delta-adjusted treatment of holdings in instruments without a "delta 1" profile. If the nominal basis is used, any resulting disclosure must include additional information (see "When and how must disclosures be made?" below).

What is the denominator?

As is currently the case, the denominator will be the issuer's total voting rights in issue based on its most recent month end disclosure and disregarding any treasury shares held by the issuer. At the time of writing this update, this is true even for disclosures in respect of unissued shares (see "Are convertible securities and other rights over unissued shares caught?").

Which interests must be aggregated under the new rules?

Positions in CFDs or similar instruments must be aggregated with interests in the underlying shares. Using the same basis as the current regime, they must also be aggregated with "indirect" interests. For example, CFD holders will need to aggregate their holdings with interests held by:

- their parents and subsidiaries (subject to exceptions);
- third parties on the CFD holder's behalf;
- concert parties with whom they have an agreement to adopt, by concerted exercise of their voting rights, a lasting common policy towards the management of the issuer of the underlying shares.

Are instruments referenced to a basket or index of shares caught?

Financial instruments referenced to a basket or index of shares will only be caught if they are "connected to the avoidance of" the disclosure requirements and the shares in the basket or index represent:

- 1% or more of the class of shares in issue; and
- 20% or more of the value of the securities in the basket or index.

You are not required to aggregate baskets or indices that do not individually meet the above criteria. If the criteria are met in respect of a basket or index, an instrument referenced to that basket or index will be deemed to have a similar economic effect to qualifying financial instruments.

Are convertible securities and other rights over unissued shares caught?

FSA guidance is that instruments giving a legal right to acquire shares will be caught. In the final policy statement, the FSA announced for the first time that this will be the case even if the shares to which the right relates have not yet been issued (e.g. for convertible bonds and warrants). They will be deemed to have a similar economic effect to qualifying financial instruments, which give a legal right to acquire already issued shares. Where such a right is itself subject to 'true conditionality' beyond the control of any of

the parties (i.e. a future uncertain event, such as shareholder approval), the FSA has acknowledged that disclosure requirements are not triggered until such conditionality is satisfied. The practical application of this concept is still being explored by the FSA and unfortunately it looks likely that clarity will only emerge after 1 June.

What is the impact on rights issues?

Our understanding of the current position is set out below.

Nil paid rights will be caught by the disclosure requirement and will be treated as if they were acquired on the allotment date. Where the allotment is conditional on an event outside the holder's control, the disclosure requirement will not be triggered until the condition is satisfied. This means in most cases that the disclosure requirement will not be triggered until the nil paid rights are admitted to trading. Because of the applicable denominator (see above), some shareholders in companies carrying out rights issues will therefore find that the incremental effect of the nil paid rights triggers a disclosure requirement without having taken any active step. The same shareholder may then have to subsequently make a second disclosure by reference to the enlarged share capital when next announced by the issuer.

We, together with a number of City practitioners, have been lobbying the FSA to provide relief where the 'denominator mismatch' forces disclosures which would not otherwise be required - both for rights issues and open offers. We will issue a further update if the position changes.

Are underwriting/sub-underwriting commitments caught?

Our view is that, for multiple reasons, underwriting/sub-underwriting commitments should not be disclosable under DTR 5 (unless and until there is any allocation of the 'stick'). The FSA has now confirmed to us that such commitments will not on 1 June be treated as caught by the incoming regulations. However, it has reserved the right to revise this approach.

Who must disclosure be made to?

Disclosure must be made to the issuer of the underlying reference shares. If those shares are admitted to trading on a regulated market (as opposed to a "prescribed market", such as AIM), disclosure must also be made to the UK Financial Services Authority.

When must disclosures be made?

Disclosures must be made as soon as possible and, in any case, within two trading days of the day after the date on which the person:

- learns, or should have learned, of the transaction, of his entitlement to exercise voting rights or of a change in delta which results in a disclosure threshold being reached or crossed;
- is informed about events changing the breakdown of voting rights with the effect that his holding reaches or crosses a disclosure threshold.

In relation to disclosures triggered by the new rules coming into force on 1 June, the trade will be deemed to have occurred on 1 June and so the disclosure will need to be made no later than 3 June.

How must disclosures be made?

Current requirements relating to the content of disclosures will continue to apply, but disclosures will additionally need to reference (as applicable):

- the aggregate of voting rights deemed held through different CFDs and similar instruments; and
- the aggregate of voting rights held as shareholder, as a direct or indirect holder of qualifying financial instruments and through CFDs or similar instruments.

Between 1 June 2009 and 31 December 2009, any disclosures made on a nominal basis in respect of derivative instruments without a "delta 1" profile, must additionally include:

- the total number of voting rights relating to the underlying reference shares; and
- the strike or execution price of each such instrument.

As is currently required, if the underlying reference shares are admitted to trading on an EEA regulated market, Form TR-1 must be submitted electronically to the FSA and to the issuer within the two trading day time limit. The issuer must then notify the market (e.g. by forwarding the TR-1 to a RIS). A new version of Form TR-1, updated to reflect the new rules, can be found at Appendix 2 to the FSA's policy statement: http://www.fsa.gov.uk/pubs/policy/ps09_03.pdf.

Can someone else make the disclosure for us?

As is currently the case, persons required to make a disclosure may:

- appoint a third party to do so on their behalf;

- arrange for a joint disclosure to be made with another person; or
- if the person is an undertaking, rely on a disclosure made by its parent.

This will not affect your responsibility for your compliance (or failure to comply) with the rules.

Are there any exemptions?

CFD writers acting in a client-serving capacity (i.e. where they simply act as intermediaries and provide liquidity) may be able to benefit from a new exemption in respect of transacting (or hedging) non-proprietary business. Persons wishing to use this exemption will have to certify annually to the FSA that they meet the qualifying conditions to do so.

Intra-group transfers, where a position is moved to another group company, will not be caught provided that:

- the "secondary" transfer is effected solely for book-keeping (i.e. tax or accounting) purposes and is not connected to the avoidance of disclosure requirements; and
- the initial, "primary" transaction either was disclosed or (due to an exemption) was not required to be disclosed.

If the above criteria are not met, intra-group transfers will be caught on the basis that they have a similar economic effect to "qualifying financial instruments".

Other exemptions provided for in the current rules (such as those for certain firms holding instruments within the trading book and certain investment managers) remain unchanged.

Further information

If you would like further information or advice on the new rules please contact Jane Tuckley, Richard Spedding or your usual Travers Smith contact.

Travers Smith LLP
May 2009

Travers Smith LLP
10 Snow Hill
London EC1A 2AL
T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

www.traverssmith.com

Jane Tuckley
Partner – Financial Services and Markets
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

Richard Spedding
Partner – Corporate and Hedge Funds
richard.spedding@traverssmith.com
+44 (0)20 7295 3284

Travers Smith LLP is a limited liability partnership registered in England and Wales under number OC 336962 and is regulated by the Solicitors Regulation Authority. The word "partner" is used to refer to a member of Travers Smith LLP. A list of the members of Travers Smith LLP is open to inspection at our registered office and principal place of business: 10 Snow Hill, London, EC1A 2AL. We are not authorised under the Financial Services and Markets Act 2000 but we are able, in certain circumstances, to offer a limited range of investment services because we are members of the Law Society of England and Wales and regulated by the Solicitors Regulation Authority. We can provide these investment services if they are an incidental part of the professional services we have been engaged to provide. The information in this document is intended to be of a general nature and is not a substitute for detailed legal advice.