

Financial Services and Markets

FSA publishes final rules on disclosure of contracts for differences and similar financial instruments

The FSA has published its final rules on disclosure of contracts for differences ("CFDs") and similar financial instruments.

The rules will come into force on **1 June 2009**, not 1 September 2009 (as the FSA had previously indicated). Affected persons will therefore need to ensure they are able to meet the requirements in time for the new June deadline.

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.

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

What does DTR 5 currently require?

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?

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); 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.

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 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 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. This is true even for disclosures in respect of unissued shares (see "Are convertible securities 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 caught?

FSA guidance is that instruments giving a legal right to acquire shares (e.g. convertible bonds and warrants) will be caught. This will be the case even if the shares to which the right relates have not yet been issued. They will be deemed to have a similar economic effect to qualifying financial instruments, which give a legal right to acquire already issued shares.

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 and how 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:

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- 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.

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 in the Financial Services and Markets Department or your usual Travers Smith contact.

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