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Making a Real Difference? FSA Consults on Greater Disclosure of CfDs

On 12 November the FSA published a consultation paper (CP07/20) proposing greater disclosure of significant "economic interests" in UK shares admitted to trading on a regulated or other prescribed market (this will include the London Stock Exchange and the AIM market). Although the proposals cover other derivative instruments with the same effect, the consultation focuses on "contracts for differences" ("CfDs"). The consultation period closes on 12 February 2008.

A CfD gives the holder economic exposure, which can be long or short, to the movement in the price of the underlying share over the period of the contract. CfDs tend to be open-ended, but may be closed out by the holder on demand. The buyer receives from or pays to the seller the difference between the value of the share when the contract is closed out and the value at the time of the contract. CfDs usually do not confer the right to take delivery of the underlying shares in place of cash settlement, and do not confer ownership rights (such as voting rights) in relation to the shares. Unless the CfD holder has a formal or contractual right to exercise voting rights, or acquire underlying shares, the FSA's Disclosure and Transparency Rules do not currently apply in respect of the CfD.

The FSA notes that over the past five years, the CfD market in the UK has grown significantly, with current estimates suggesting that around 30% of equity trades are in some way driven by CfD transactions. The FSA is concerned that as CfD positions do not need to be disclosed, issuers are unable to know who has significant economic exposure to their shares, and it identifies three potential market failures which might arise from non-disclosure of CfDs: inefficient price formation, distorted market for takeovers, and diminished market confidence.

Accordingly, the FSA is putting forward two separate options for consultation (it raises a third option, that of maintaining the status quo, but only to dismiss it). The first is a package of specific measures aimed at strengthening the current disclosure regime. It would deem CfDs to have access to voting rights, unless the following conditions are met:

- the agreement relating to the CfD must explicitly preclude the holder from exercising or seeking to exercise voting rights;
- the terms of the agreement must exclude further arrangements or understandings in relation to the potential sale of the underlying shares; and
- there must be an explicit statement by the CfD holder that it does not intend to use its CfDs to seek access to voting rights.

If these three conditions (which the FSA terms a "safe harbour") are not met, then the interests in the CfDs must be aggregated with any other instrument that confers voting rights, and the combined total must be disclosed if it reaches a threshold of 3%.

Under this proposal, issuers of shares would also be able to compel a CfD holder to disclose its interest in the issuer, provided that the CfD holder had an economic interest in 5% or more of the issuer's shares. For this purpose, the "safe harbour" mentioned above would not apply.

FSA's alternative proposal is a general disclosure regime, requiring disclosure of all economic interests of 5% or more in an issuer's shares held through CfDs. This threshold would operate separately from the threshold for shares and other qualifying financial instruments, and there would be no aggregation across the two. This proposal would lead to simpler rules than the first proposal, but it would also, in the FSA's view, be more costly, with an estimated total direct cost of £20-50 million. Though the FSA is consulting on both options, the first is clearly its preferred choice.

Disclosure of CfDs is already required in the UK, albeit only in limited circumstances. The Takeover Panel has since November 2005 required disclosure of all derivative interests during an offer period where those interests, alone or in combination with actual holdings of shares, form 1% or more of the target company. The FSA has made it clear that its CfD disclosure requirements would not apply if a disclosure has already been made under the Panel's rules, which would avoid duplication of disclosure for firms.

Given that a precedent of sorts exists in the Takeover Panel's rules, it is perhaps not surprising that the FSA has focused on this area more generally. And this focus is consistent with the recently published consultation paper of the Hedge Fund Working Group (hedge funds being the major holders of CfDs), which acknowledged that companies have a right to know who owns them or who has the ability to easily obtain significant voting power, and recommended that the regulators take action to introduce a regime similar to that of the Takeover Panel. But since the FSA expects the majority of CfDs to fall within the "safe harbour" it is proposing, one wonders what difference the new proposals will make if this option is adopted. This is particularly so given that the FSA concedes that the major market failure risk – a distorted market for takeovers – has already been addressed by the changes the Takeover Panel made two years ago. And if a CfD holder has no voting rights in the shares to which the CfDs refer, and will not seek access to such rights, let alone exercise them, one wonders what value there will be to a company to learn that such a holder has a 5% or more "interest" in its shares. Perhaps the FSA should not have dismissed the status quo option so lightly.

That said, hedge and other funds that are regular holders of CfDs as part of their investment strategy can clearly expect to have some additional regulation in this area sometime in the new year (the FSA suggests that the draft rules may be in force by September 2008). Those who think that increased disclosure along the lines proposed by the FSA will make the market less efficient and/or have other adverse effects on their business are strongly advised to respond to the consultation.

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