NEW DISCLOSURE REGIME FOR CONTRACTS FOR DIFFERENCE TO TAKE EFFECT IN JUNE 2009

The UK Financial Services Authority (FSA) has recently announced that the new disclosure regime for Contracts for Difference (CfDs)[1] will now take effect from 1 June 2009, where previously it was not scheduled to apply until September 2009.

The new regime will require investors who hold 3% or more of a company's voting equity through either shares, CfDs, or other relevant derivatives, or an aggregation of shares, CfDs, and other relevant derivatives, to disclose their stakes.

WHY HAS THE FSA MADE THE CHANGES?

The FSA states that its decision to bring forward the implementation of the new rules is due to ongoing market turmoil, claiming that the new rules are a very significant step in improving market transparency.

Save in relation to companies subject to a takeover offer, and save as required by the new short selling rules[2], there was previously no requirement in the FSA's Disclosure Rules and Transparency Rules to disclose holdings of CfDs, provided they were cash settled and did not confer voting rights.[3] The FSA is concerned that, without disclosure, companies cannot identify who has significant economic exposure to their shares which could result in inefficient pricing in the market.

The nature of a CfD means that a holder can gain economic exposure to a particular share without being required to pay the full market value of that share. The holder gains no voting rights, but can usually switch the contracts into holdings of the underlying shares. This has meant that CfDs have been used for many years to build positions in public companies without the need for any public disclosure.

1 A CfD is a derivative instrument that gives the holder an economic exposure, which can be long (that is, where the holder gains from a rise in the underlying share price) or short (that, is where the holder gains from a fall in the underlying share price) to the change in price of a specific share over the life of the contract. The contract is normally open-ended and can be closed out by the holder on demand. Usually the contract will be cash settled and will not confer the right to take delivery of the underlying shares. In addition, it does not usually give ownership rights, such as voting rights.

2 http://www.arnoldporter.com/resources/documents/CA_BanOnShortSellingOfUK-FinancialSectorCompaniesToBeLifted_011409.pdf

3 DTR Rule 5

London
+44 (0)20 7786 6100

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

WHAT ARE THE REQUIREMENTS THAT WILL APPLY?

On 23 October 2008, the FSA published its feedback and policy statement[4] on disclosure of CfDs setting out the proposed policy. In its recent policy statement issued on 3 March 2009[5], the FSA confirms that, after receiving support to its proposals outlined in October 2008, it will be implementing the new requirements on the basis generally set out in the October 2008 paper.

This means that there will be a single threshold for both shares and CfDs requiring disclosure once a holding reaches 3%, and subsequent disclosures being required where holdings increase or decrease above or below the 1% steps set out in the Disclosure and Transparency Rules.

An exemption for CfD writers will be introduced to reduce unnecessary disclosures and reduce the cost of implementing the systems for disclosure. This will be similar to the Takeover Panel's disclosure exemption for banks and securities houses with Recognised Intermediary status.

Whilst most proposals have not changed, the March 2009 paper does set out two areas where the FSA is changing its approach:

First, in relation to the basis on which disclosures should be calculated, the FSA has decided that disclosures should be made on a delta-adjusted basis, save that reporting on either a nominal or a delta adjusted basis will be allowed for a transitional period of 7 months from implementation. The delta-adjusted basis is explained below.

Second, the FSA confirms that the new disclosure rules will be effective from 1 June 2009.

WHAT IS A DELTA-ADJUSTED BASIS?

The delta of an equity derivative represents how the pay off from that derivative changes in relation to a change in the price of the underlying equity. For example, a CfD would usually have a delta of 1 as it perfectly mirrors the change in the underlying share price. However, an option could have a delta that varies constantly, so any required calculation of the position would be based on the delta at the end of the trading day.

4 http://www.fsa.gov.uk/pubs/cp/cp08_17.pdf

5 http://www.fsa.gov.uk/pubs/policy/ps09_03.pdf

Disclosure on a delta-adjusted basis can be illustrated as follows:

Company A has one million shares.

A CfD for 100,000 share in Company A has a delta of 1. Therefore the appropriate calculation would be (100,000 x 1) / 1,000,000 which gives a disclosure of 10% of Company A's shares.

A cash settled call option for a notional 100,000 shares in Company A has (at transaction date) a delta of 0.2. Therefore the calculation (100,000 x 0.2) / 1,000,000 gives an answer of 2% of the company's shares and no disclosure is required.

To determine the delta value, the FSA is of the view that standard option pricing models are readily available.

OTHER POINTS TO NOTE

The new rules catch derivatives in addition to CfDs. The precise wording of the new instrument states that in addition to disclosing interests in "qualifying financial instruments,"[6] a person must make a notification in respect of any financial instruments held directly or indirectly which are referenced to the shares of an issuer and have similar economic effects to (but which are not) qualifying financial instruments.[7] The effect is that although the focus is on CfDs, the FSA intends that all similar economic interests are disclosed.

We hope that you have found this client advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

Jeremy Willcocks
+44 (0)20 7786 6181
Jeremy.Willcocks@aporter.com

Fiona Ellett
+44 (0)20 7786 6120
Fiona.Ellett@aporter.com

6 These are transferable securities and options, futures, swaps, forward rate agreements and any other derivative contracts, as referred to in Section C of Annex 1 of the Markets in Financial Instruments Directive (MiFID), which shall all considered to be qualifying financial instruments provided that they result in an entitlement to acquire, on the holder's own initiative alone, under a formal agreement, shares to which voting rights are attached, already issued of an issuer whose shares are admitted to trading on a regulated market or a UK prescribed market.

7 See new rule 5.3.1R