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Disclosure of contracts for difference: are you ready?

New rules will require disclosure of long contracts for difference ("**CfDs**") and similar derivative products from 1 June 2009 in the UK. They extend the existing disclosure of major shareholdings regime in Chapter 5 of the Disclosure Rules and Transparency Rules ("**DTR 5**") published by the Financial Services Authority ("**FSA**"). Currently, a person must notify certain issuers of the percentage of voting rights they hold once prescribed thresholds are triggered. For UK issuers, the thresholds are three per cent. of the voting rights and then each higher whole percentage point. On 8 May 2009, the FSA published helpful questions and answers on the disclosure of CfDs on its website.

The new system will require aggregation of all voting rights in specific UK issuers which a person holds (or is deemed to hold) as the owner of:

- shares;
- so-called "qualifying financial instruments". Broadly, this means instruments giving the owner an unconditional right to acquire shares to which voting rights attach; or
- long CfDs or similar derivative products which are not qualifying financial instruments but are referenced to shares and have a similar economic effect to qualifying financial instruments. This will be the case if the holder has, in effect, a long position on the economic performance of the shares.

Currently, CfDs and related derivative products fall outside of the scope of DTR 5, unless the instrument explicitly gives a right to acquire, or gives access to the voting rights attached to, shares held as a hedge by a CfD writer.

Which issuers: The new elements of the disclosure regime only apply to UK-incorporated issuers whose shares are admitted to trading on:

- a regulated market in the EU (e.g. the London Stock Exchange's main market); or
- a prescribed market (e.g. AIM).

Which products: The FSA has deliberately adopted a principles-based approach in shaping the new requirements to discourage the creation of innovative products in a bid to avoid disclosure. Amongst other things, this catches contracts for difference and other derivative products such as cash-settled options and convertibles over unissued shares. Short positions are not covered by this regime.

Instruments which give a legal right to acquire shares which are not yet issued (such as convertible bonds and warrants) are also caught. The FSA's view is that they allow for the acquisition of voting rights in an issuer and as such could be used to build stakes in companies. On the other hand, where an instrument gives rise to a conditional right to acquire a CfD or similar derivative product, provided the transaction is subject to conditions beyond the control of both parties, the FSA expects a notification to be made only when the relevant conditions are fulfilled. This would cover, for example, nil paid rights and placee rights which are subject to shareholder approval. It would not cover the choice of whether to exercise an option as that is within the control of at least one party.

No transitional grace period for CfD disclosures: Importantly, the FSA has confirmed that a person will be considered to have reached or crossed a relevant disclosure threshold on 1 June 2009, even if the relevant financial instruments were acquired before that date, if those instruments (when aggregated with other existing holdings) result in a threshold being reached or crossed.

Aggregation: In determining whether a relevant threshold has been reached or crossed (with respect to a UK issuer) holders must aggregate their direct and indirect holdings in shares, qualifying financial instruments and CfDs. The FSA has published a modified TR1 disclosure form to enable investors to provide a breakdown of their aggregated holding between the different categories.

Denominators: The denominator to be used for determining whether a disclosure is required is (as now) the issuer's total voting rights in issue based upon that issuer's most recent total voting rights disclosure. This is the case even if the disclosure relates to convertibles over unissued shares.

Instruments referenced to baskets: A financial instrument referenced to a basket or index of shares will not be disclosable unless the shares in that basket/index represent one per cent. or more of the class in issue or 20 per cent. or more of the value of the securities in the basket/index (or both) or if use of the financial instrument is connected to the avoidance of notification.

Where a position held via a basket or index changes passively (for example, due to a change in the composition of the basket/index or a change in the value of the relevant securities), the FSA does not expect disclosure if a threshold is only reached because of that change. However, if a person enters into a transaction after that change, they must use the new characteristics of the basket/index to calculate their position.

Delta-adjusted hedging: Disclosures must be made on a "delta-adjusted basis". Any financial instruments which do not have a "delta 1" profile (i.e. those instruments which do not have a linear, symmetric payoff profile in line with the underlying shares such as cash-settled options) will be considered to have an economic effect, in relation to the underlying shares represented, only in the proportion which is equal to the delta of the instrument at any particular point in time. For example, an instrument with a delta of 0.5 on a particular day, provides a "similar economic effect" in only half the underlying shares represented. The FSA thinks that disclosure on this basis will more accurately reflect the actual extent of the economic interest held at any one time.

However, the FSA also recognises that requiring immediate disclosure on a delta-adjusted basis might cause practical difficulties given that, for example, in the case of a cash-settled option, the holder may need to recalculate the delta-adjusted holding on a daily basis as the delta alters over time. Accordingly, the FSA has introduced a transitional period running to 31 December 2009 during which positions can be reported on either a delta or nominal basis. Where a nominal basis is used, holders will need to include the strike or exercise price of each financial instrument reported and the total number of voting rights relating to shares referenced by each financial instrument reported.

Exemptions: There is no requirement to disclose a transaction under DTR 5 where CfD writers are effectively acting as client-serving intermediaries (for example, where a CfD writer writes a short CfD for a client and as a result takes a long position itself). That is provided certain conditions are satisfied in relation to the writer's authorised status and the systems it has in place to distinguish when it is acting on a client-serving transaction.

Relationship with Takeover Code: DTR 5, as amended, will not switch off during an offer period under the Takeover Code. Accordingly, there will be dual notification obligations in relation to long CfDs and similar derivative products during an offer period under both DTR 5 and the Takeover Code.

Enforcement: The FSA initially intended not to take an enforcement led approach to ensuring compliance with the disclosure regime under DTR 5. However, due to current market conditions, the FSA has stated that it will consider the use of public disciplinary action if warranted. Also, given that the new regime represents a significant extension of the current disclosure obligations, the FSA will be keeping the practical operation of the rules under review. So, we can expect it to be taking a close interest in the functioning of the regime and, in particular, the types of products which are or are not being disclosed.

The FSA also acknowledges that, because there is no set list of financial products which are covered by the regime, it could capture a broad range of products. It will be expecting holders of instruments, having taken appropriate advice if necessary, to come to their own conclusions as to whether they trigger a disclosure obligation and will not be giving advice on whether actual or proposed individual transactions are caught.

Action points for writers and holders of CfDs:

- take stock of current holdings and assess whether or not they will trigger a disclosure obligation on or after 1 June 2009;
- bear in mind that there is no transitional period for disclosures of existing holdings;
- ensure you are in a position to calculate affected holdings on a delta-adjusted basis (after the transitional period to 31 December 2009 during which calculations on a nominal basis are also permitted).

Action points for relevant UK issuers:

- be prepared for a potential influx of TR1 disclosure forms in relation to existing holdings on or around 1 June 2009;
- ensure you have systems in place to publish the information as soon as possible by releasing details to a Regulatory Information Service. UK issuers with shares admitted to trading on a regulated market must do this by no later than the end of the next trading day.

If you have any questions or require specific advice on any matter discussed in this publication, please contact Annabel Evans (T: +44 20 3130 3858 or E: aevans@mayerbrown.com), Michelle Wyatt (T: +44 20 3130 3584 or E: mwyatt@mayerbrown.com) or your regular contact at Mayer Brown.

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