Financial Services Authority

Disclosure of Contracts for Difference – Questions & Answers: Version 2

Policy Statement PS 09/3 published in March 2009 set out the final Handbook text for the disclosure of Contracts for Difference (CfDs). These rules come into force on 1 June 2009 and we are publishing these Questions and Answers (Q&As) to cover some key issues which may assist market participants' understanding of the new regime. The Q&As should be considered in conjunction with the relevant Consultation Papers and Policy Statement relating to the rules. The Q&As do not constitute FSA guidance.

This version of the Q&As, published on 11 June 2009, includes a new Q&A 16 in respect of underwriting and a new Q&A 19 in respect of the treatment of rights/entitlements. The other Q&As are unchanged.

PURPOSE & SCOPE

1. Why do we need new disclosure rules?

We have widely consulted on the introduction of these new rules. The new rules are being implemented in response to a number of market failures that are more widely discussed in Consultation Papers (CPs) CP07/20 and CP08/17. Persons interested in the policy debate behind the introduction of the new rules are advised to review these CPs and our responses in the corresponding Policy Statement, PS09/3.

2. When do the new rules come into force?

The new rules come into force on 1 June 2009, although there will be a transitional period (for delta reporting) until 31 December 2009 (see Question 24). A person will be considered to have reached or crossed a relevant disclosure threshold on 1 June 2009, regardless of when the financial instruments having similar economic effect to qualifying instruments were acquired, if these instruments (when aggregated with other existing holdings) result in a threshold being reached or crossed.

3. What is the scope of the new rules?

The new elements of the disclosure regime broadly apply to UK incorporated issuers whose shares are admitted to trading on a regulated market (and whose home state for the purposes of the Transparency Directive (TD) is the UK) or on a prescribed market. For example, since AIM is a prescribed market, the new rules apply to those issuers admitted to trading on AIM that are, broadly speaking, incorporated in the UK.

The new elements of the regime do not apply to non-UK issuers, whether or not their shares are admitted to trading on a UK regulated or prescribed market and whether or not their home state is the UK for the purposes of the TD. The regime for non-UK issuers does not change and continues to cover direct and indirect shareholdings and qualifying financial instruments.

4. **Are similar rules applicable to issuers all across Europe?**

No. Such rules are not required by the TD and we have introduced the new disclosure rules because we felt that certain types of interests in UK issuers, over and above those covered by the TD, should be disclosed. We are aware that certain European countries are currently also considering extending the scope of their disclosure rules.

5. **Do the new rules apply to a UK company admitted to trading on a regulated market elsewhere in the EU?**

Yes. If a company is, broadly speaking, incorporated in the UK, has chosen the UK as its home state under the TD and its shares are admitted to trading on a regulated market in the EU, but not in the UK, the new disclosure rules would still apply.

6. **Do investors domiciled outside the UK need to comply with the new rules?**

Yes. Like the existing rules on disclosure of major shareholdings, the new rules apply to all persons irrespective of where they are domiciled or on which market they trade the financial instruments that give them a disclosable interest in the shares of the relevant UK issuer.

7. **How are exchange-traded instruments treated?**

We have considered whether instruments, with similar economic effects to qualifying instruments traded on-exchange, may fall out of scope because the existence of a central counterparty means the possibility of obtaining direct access to the underlying shares held by the ultimate counterparty is limited. But we consider that, given market practice in this area, the holder of a long CfD position may know that there is likely to be ready access to the underlying shares when the contract is closed and so will be in a better position to obtain them. As a consequence, such instruments fall within scope.

8. **How do the new rules interact with the Takeover Panel's disclosure requirements?**

Investors may need to comply with both regimes as neither regime is being 'switched off' when the other is triggered. The two sets of rules are similar in places. For instance, the client-serving intermediary exemption was based on a similar exemption in the Takeover Code.

9. **How do the new disclosure rules interact with the short-selling disclosure provisions?**

The disclosure regimes are independent of each other as the short-selling provisions relate to net short positions and the new DTR 5 rules relate to long holdings.

CALCULATING A DISCLOSABLE HOLDING

10. **What types of financial products are covered by the new rules?**

There is no set list of financial products that fall under the new rules, as financial markets invent new products on a regular basis and the regime is designed to ensure that disclosure is not avoided on the grounds of a technicality. Instead, the rules are drafted in a principles-based way to ensure that all financial products capable of having a similar economic effect to qualifying instruments are caught. This potentially captures a broad range of products.

It should be noted that we expect holders of instruments, having taken appropriate advice if necessary, to come to their own view as to whether they fall within scope. We are not in a position to consider on a firm's behalf whether individual transactions undertaken or proposed by market participants fall within scope.

11. Do intra-day holdings of financial instruments that have similar economic effect to qualifying financial instruments require disclosure?

No. We would not expect a holding acquired during a day but disposed of prior to the end of the day to be disclosed (as is already the case for qualifying financial instruments). This is consistent with DTR 5.8.11R, which sets out that in determining whether a notification is required, a person may assess their holding at a point in time up to midnight of the day for which the determination is made.

12. Is it necessary to aggregate all direct and indirect holdings of financial instruments?

Yes. All financial instruments giving access to voting rights or that are referenced, in whole or in part, to an issuer's shares and, in effect, give a long position in the economic performance of the shares, have to be aggregated across the categories of instruments held. For example, if you hold 5% of voting rights by directly owning the shares, 3% by virtue of holding qualifying instruments and 2% by virtue of holdings in CFDs, you have to disclose a position of 10%.

However, holders are required to disclose a detailed breakdown of the composition of their holding (i.e. respectively, the amount they hold through each of: direct or indirect shareholdings; qualifying financial instruments; and financial instruments with similar economic effect).

13. What is the difference between qualifying financial instruments and financial instruments with a similar economic effect to qualifying instruments?

Voting rights held by virtue of holdings in qualifying financial instruments have been disclosable for some time under the current rules in DTR 5.3. They are, in short, financial instruments that give a legal right to acquire (on the holders own initiative alone) shares already in issue and with voting rights attached. Financial instruments with a similar economic effect to qualifying instruments are instruments that do not have a legal right to acquire shares, but have a similar effect in practice. We think this will generally be the case if the instruments are referenced to the issuer's shares and the holder has a long position on the economic performance of the shares, whether or not the instrument is capable of being settled physically in shares or in cash. Examples are CFDs, cash-settled call options or the writing of a put option, as each is referenced to and gives a long position in the economic performance of the shares.

14. When is an acquisition or disposal of a financial instrument with similar economic effect to a qualifying instrument regarded as effective, in circumstances where the transaction is conditional upon the occurrence of a future uncertain event?

In our view, the analysis in DTR 5.1.1R (4) can be applied to the acquisition or disposal of instruments caught under the new rules. Where there is true conditionality about whether the transaction will take place (because it is dependent on whether a future uncertain event will occur, i.e. the transaction is subject to conditions beyond the control of any of the parties to it), we would expect a notification to be made for a disposal or acquisition only when the future uncertain event occurs. For example, nil paid rights and placee rights would not be disclosable until the necessary shareholder approvals have been passed, as this is a condition beyond the control of any of the parties. Conditions within the control of at least one of the parties, such as the choice of whether to exercise an option, do not fall into this category.

15. Are financial instruments covered by the new rules if they relate to shares that are not yet issued?

Yes. Our view is that instruments such as convertible bonds and warrants can be considered to be 'referenced' to shares in issue, though they may only give a legal right to acquire shares that are not yet issued. Such instruments ultimately allow for the acquisition of voting rights in the issuer and therefore have similar economic effects to qualifying instruments. These instruments can be used to build stakes in companies (or be part of strategies including other instruments such as CfDs) so excluding them from scope would potentially undermine the objectives of the new regime.

Where notifications of convertibles are made, the denominator used by the issuer should remain unchanged and be that in the most recent DTR 5.6 disclosure by the issuer.

16. How should underwriting obligations be treated under the new rules?

A pre-condition for an instrument to be caught by the new regime is that it must be a 'financial instrument' as defined in the Markets in Financial Instruments Directive (MiFID). We do not consider that 'conventional' underwriting or sub-underwriting contracts in relation to a primary markets rights issue would likely constitute a financial instrument under MiFID. Consequently, any long position in the economic performance of shares held by a lead or sub-underwriter by virtue of obligations under such underwriting contracts would not be disclosable under the new rules.

17. Can a long position be netted against a short position as per the short-selling disclosure regime?

No. The focus is on long positions in the economic performance of shares. Accordingly, all long positions have to be disclosed on a gross basis, irrespective of an offsetting short position.

18. How are baskets of shares or indicies treated?

We are following the approach used by the Takeover Panel, which is slightly different from the approach in the short-selling disclosure provisions. So a derivative referenced to a basket

or index is disclosable if the relevant securities represent 1% or more of the class in issue, or 20% or more of the value of the securities in the basket/index, or both. A derivative referenced to a basket or index where the relevant securities fall below the relevant threshold would still be considered to have similar economic effect to a qualifying instrument (and therefore require disclosure) if the use of the financial instrument was connected to the avoidance of disclosure.

We take the view that where a position held via a basket or index changes passively (for example, due to a change in the composition of an index/basket or a change in the value of the relevant securities) we would not expect a new disclosure if a disclosure threshold was reached or passed solely as a result of the change to the basket/index. If, however, a person entered into a transaction subsequent to the change in the index/basket, they should use the new characteristics of the basket/index when calculating its position.

Where there are financial instruments referenced to a series of baskets, which are under the thresholds individually but over them in aggregate, we do not expect disclosure on an aggregated basis except where the use of the instruments is connected to the avoidance of notification.

19. Do rights issued under a rights issue require disclosure under the new rules?

We consider that a right constitutes a financial instrument having similar economic effect to a qualifying instrument. A right therefore falls within the scope of the new rules. However, we acknowledge that a person who passively receives rights solely as a consequence of being an existing shareholder will be maintaining their proportionate position and will not be changing their long position in the economic performance of the shares. Consequently, we do not expect persons who have been assigned rights under a rights issue to include the rights in the calculation of their position in the shares. But we would expect any person who actively acquires or disposes of rights during a rights issue (so that their proportionate holding post the issue of the new shares will change relative to that held prior to the new shares being issued) to include all the rights, whether acquired actively or passively, in their calculation of their position in the shares.

When calculating a change in position resulting from an active acquisition/disposal of rights, the person should use the issuer's most recent DTR 5.6 disclosure as the denominator in the calculation (see Q&A 20. below)

The same analysis would apply to a pro-rata entitlement to acquire shares under an open offer (i.e. a person who maintained their proportionate holding by virtue of inaction would not need to disclose the entitlement).

We intend to consult on a specific exemption in the rules in respect of this matter.

20. What is the relevant denominator for calculating a percentage holding?

The denominator has not changed from the previous regime and, in accordance with DTR 5.8.8R, remains the total number of voting rights as per the most recent DTR 5.6 disclosure by the issuer. We are aware that the use of the undiluted DTR 5.6 figure as denominator in circumstances such as a rights issue, may not precisely reflect the true economic exposure of an investor. However, as per the existing DTR 5 regime and in the short-selling disclosure

regime, it is important that the entire market uses the same convention and for consistency purposes we consider that the most recent DTR 5.6 disclosure remains the appropriate denominator.

21. Do holdings in financial instruments having similar economic effect to qualifying instruments, which were acquired prior to the new rules coming into force, need to be taken into account under the new regime?

Yes. If a person holds, at the time the new rules come into force, financial instrument having similar economic effect to qualifying instruments, which when aggregated with their holdings in shares and/or qualifying financial instruments, would lead them to reach or exceed a disclosure threshold, they will need to disclose their new aggregated position, even in the absence of any new dealing after the rules come into force. For the purposes of determining the timescale for notification of the new position, a person will be considered to have reached or crossed a relevant threshold on 1 June 2009, regardless of when the pre-existing financial instruments having similar economic effect to qualifying instruments were acquired.

22. Do the new rules lead to double counting of positions?

Under the new rules, holdings in a wider category of instruments will be disclosable which may in some instances lead more notifications being made in respect of the same share capital. However, the phenomenon of notifications representing over 100% of existing share capital already exists under the current rules. For example, if an investor holds 60% of the voting rights by direct ownership of shares, and if this investor granted a call option for all their shares to a second investor, the two investors together would, under existing rules, have to disclose their interest in 60% of the voting rights, which together appears to relate to 120% of the issuer's share capital. That said, the notifications require a breakdown of how interests in voting rights are held (e.g. either by direct or indirect shareholding, or through holding of a financial instrument with the shares underlying) so that it should be clear how the various interests in the same voting rights are comprised.

Although the new rules may accentuate the situation by making further instruments disclosable (for example, the CFD provider may have to disclose a position in the shares that they are holding as a hedge at the same time as a CFD buyer is disclosing their position), we do not believe the market is or will be confused by these disclosures and is able to work out the underlying situation through consideration of the detailed information in the notification.

23. How are intra-group transactions treated?

We will not expect positions resulting from internal movements between accounts or between group companies to have 'similar economic effect' when those movements are simply for tax or accounting purposes, provided that the original transaction had been disclosed if required (or included in the calculation for disclosure) and, if not required, the basis for that non-disclosure continues. This approach to the interpretation of 'similar economic effect' is consistent with the underlying policy to reduce, where possible, disclosures of information that have no value for the market.

24. Is there a transitional period for companies to adjust to reporting on a delta-adjusted basis?

Yes. As a temporary measure until 31 December 2009, making delta-adjusted disclosures is an option, but not a requirement. During this transitional period it is acceptable to disclose a nominal position and include sufficient other information (such as exercise price and volume of nominal shares) so that, together with other publicly available information, the market can calculate the delta-adjusted position itself. Alternatively, the delta-adjusted position can be disclosed.

We think a delta-adjusted disclosure will better mirror an exposure in terms of shares than a nominal disclosure and we therefore consider this type of disclosure to be of more value to the market. We recognise that a delta-adjusted disclosure will require routine monitoring of a position, since the delta may change frequently.

25. Is it necessary to disclose all aggregated holdings under DTR 5 on a delta-adjusted basis?

No. Delta-adjustment is only relevant to those financial instruments with a similar economic effect to qualifying financial instruments. Qualifying instruments will continue in future to be disclosed on a nominal and not delta-adjusted basis, as required for the purposes of implementing the TD.

26. How do you calculate a delta-adjusted position?

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. A CfD, for example, would have a delta of one, as it perfectly mirrors the change in the underlying share price. Delta is a useful and relevant measure, as it is representative of the number of shares the person writing the derivative would need to hold in order to perfectly hedge its exposure under the derivative. This represents the long economic interest on the performance of the shares to which the holder of the instrument may be taken to have.

The principle of delta-adjusted disclosure would work both for CfDs and for options. A worked example of a delta adjusted disclosure is set out below.

Assume Company A has one million shares in issue.

A CfD for 100,000 shares in Company A has a delta of one. 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 (an assumption based on a number of parameters). 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.

This outcome would make sense, as the person writing the CfD would need to hold 10% of the company if it chose to hedge via shares, which is the size of holding the CfD holder has potential access to. Therefore a disclosure would be required. The person writing the option would (at this point) only need to hold 2% of the shares as a hedge, which would be below the disclosure threshold. But the option holder may need to recalculate the delta-adjusted holding on a daily basis as the delta changes over time.

EXEMPTIONS

27. There is a new exemption for client-serving intermediaries. Does it also apply to any holdings of shares or qualifying instruments?

No. The new client-serving intermediary exemption only applies to financial instruments having a similar economic effect as defined in the rules. Please see DTR 5.3.1(3),(4) & (5) for a definition of client-serving intermediary.

28. What is the purpose of the client-serving intermediary exemption? Is this exemption provided for by the Transparency Directive?

The concept is designed to exempt persons from the disclosure obligation where they hold financial instruments having similar economic effect to qualifying instruments, in order to satisfy client needs and where they themselves have no interest in using their holding to exert influence over the issuer in question. The exemption is not derived from the Transparency Directive.

29. What is the process for getting a client-serving intermediary exemption?

The detail is set out in the rules and firms should look at these. A firm wishing to take advantage of this exemption must be authorised by its home state under MiFID/Banking Co-ordination Directive (or as a third country investment firm in the UK) to: deal as principal in a client-serving capacity in financial instruments; certify that it has systems and controls to identify, distinguish and monitor between client-serving business and its proprietary business; and certify that it will not exert influence on or intervene in the management of the issuer concerned. This certification must be renewed on an annual basis and be signed by a director of the firm. A pdf copy of this certification must be emailed to: majorshareholdings@fsa.gov.uk. There are also continuing obligations placed on those relying on the exemption – see DTR 5.3.1(4).

30. How does the client-serving intermediary exemption apply to groups?

The exemption is available to a firm outside the EEA, in the same group as a MiFID/BCD authorised firm (or third-country investment firm), with equivalent authorisation from its home state regulator, subject to individual application and the provision of further certification from a Director-level representative of the MiFID/BCD authorised firm (or third-country investment firm) within its group that it meets the criteria.

31. How do the exemptions within DTR 5 interact?

The partial exemptions within DTR for market-making, trading books and investment management potentially apply under the new regime, subject to firms being able to satisfy the terms of the exemption in their particular circumstances. A person should first consider whether they can use the client-serving intermediary exemption for financial instruments with a similar economic effect as defined in the rules. If that is not the case, they have to aggregate their position across all financial instruments. If the aggregated holding reaches or crosses a relevant threshold, they need to establish whether reliance can be placed on any of the other exemptions on an aggregated basis.