

Conceal and be damned

The FSA has proposed disclosure rules that will change the derivatives landscape

A commitment to transparency is usually the common tie that binds the world's securities regulators. And yet, with the publication of the UK Financial Services Authority's policy regarding disclosure of contracts for difference (CFDs, or cash-settled long equity derivative positions), it has become clear that there is a marked difference between the speed at which different regulators, particularly the FSA and the US Securities and Exchange Commission (SEC), are bringing their rules and policies up to speed with twenty-first century financial innovations.

CFDs can take many different forms including options, swaps and forwards (whether for single shares or baskets of shares) and securities and other structured products, where payments are dependent on the performance of a share or share basket. Whatever their precise legal form, the essential characteristic of a CFD is that the holder has the right to receive a cash payment from its counterparty, the writer of the CFD, if the share referenced by the CFD increases in value (sometimes called a synthetic long position). The CFD holder does not usually have any right to acquire the share itself, nor any control of the votes attached to the share.

As a result, in many jurisdictions the CFD holder has no obligation to disclose its CFD

holding to the issuer of the shares, even if the shares would constitute a large stake in a listed company. This is in contrast to the position in most developed jurisdictions as regards physical shareholdings, which will often require public disclosure by the holder or even necessitate a mandatory tender offer for all of the issuer's shares if they represent a significant portion of the shares of the company.

Difference of opinion

Recent developments have highlighted the divergence of opinion as to whether these economic interests should be disclosed in the same way as actual shareholdings. In the red corner are the derivatives dealers and their customers, who contend that non-disclosure of CFDs is not an anomaly. They argue that the majority of CFD holders enter into such financial instruments not from a desire to obtain corporate control on the quiet but to obtain an economic interest equivalent to share ownership involving cheaper transaction costs than acquiring the shares themselves. They maintain that a major reason for the original development of the CFD market in the UK was to avoid the stamp duty levied on transfers of UK shares.

In the blue corner are the listed companies and their more traditional investors, who contend that CFDs have become an established (if unofficial) method of building up stakes in listed companies without triggering an obligation to disclose interests. They contend that even if the CFD holders do not have any legal rights to acquire the shares or control their votes, they are still able to influence the writer of the CFD, which often holds the referenced shares to hedge its CFD obligations. In their eyes, the holders of CFDs should be treated in the same way as the holders of the referenced shares themselves when it comes to disclosure.

Whatever the relative merits of the various opinions on disclosure, the global nature of the capital and derivatives markets means that a uniform approach to disclosure of these instruments is highly desirable. However, the regulators on either side of the Atlantic are far from unified in their policies.

Failure to disclose

The SEC's stance has been brought firmly into the open in recent weeks. The catalyst was a US court's ruling that British-based hedge fund group, The Children's Investment Fund (TCI), failed to disclose its acquisition of 5% of the outstanding equity of the US railroad company CSX before it launched a proxy fight for control of CSX. TCI acquired a significant portion of its interest in CSX through the purchase of a form of equity derivative – a cash-settled total-return equity swap (TRS).

Under Section 13(d) of the Securities Exchange Act 1934, disclosure is required when one beneficially owns more than 5% of a public company. Traditionally, participants in the equity derivatives markets have not regarded a TRS as constituting beneficial ownership in the underlying shares, since the aim of a TRS is to decouple the voting control and the economic exposure in respect of the underlying share.

One of the primary issues in the CSX case was whether beneficial ownership of a significant shareholding for section 13(d) purposes included rights under the TRS and should therefore have been disclosed by TCI. The SEC submitted a letter to the court stating that, except in unusual circumstances, it would not consider TRS interests to constitute beneficial ownership.

The court gave this issue significant thought but in the end found it unnecessary to reach a definite conclusion on this point. It found that on the particular facts of this case, such as the assertion by TCI to CSX that it could at any time convert its TRS position into actual shares, there was a scheme to evade the reporting requirements of Section 13(d) of the Securities Exchange Act. However, the only remedy prescribed by the court was a partial injunction preventing TCI from any further Section 13(d) violations. It did not order any damages or prevent TCI from voting any shares in CSX. Both CSX and TCI have filed appeals, so this issue may not yet be settled.

The case is interesting because it sheds light on how activist hedge funds may attempt to gain control of a company's voting stock surreptitiously in anticipation of a proxy contest. Also, it shows that a US court, despite the SEC's views, is at least receptive to arguments that synthetic equity positions might constitute beneficial ownership and therefore require disclosure.

Implications for the UK

The decision will not have gone unnoticed by the FSA in the UK. The regulator has been openly consulting market participants on CFDs, which account for a third of UK

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equity trading, for some time. Coincidentally, this month it chose to draw a line in the sand by issuing an update on its proposed policy on disclosure of CFDs.

With its policy announcement in July, the City regulator has implicitly dismissed the current views of the SEC and the market participants on equity derivatives disclosure and has given companies and investors quite clear direction on how the landscape for disclosure of CFDs on UK-listed shares will look this time next year.

Disclosure and transparency

At the moment, for UK-listed shares, the holder of a CFD in respect of those shares is not obliged to disclose its interest publicly, so long as it has no enforceable right to acquire the listed share or control its voting rights.

This contrasts with the position of a shareholder in a UK-listed company under the FSA's Disclosure and Transparency Rules (DTR). Under the DTR, the holder of 3% or more (or 5% or more, in the case of a non-UK incorporated company) of the shares of a company listed on a regulated or prescribed market in the UK must disclose the holding to the listed company.

At the time of introducing the DTR, which implements the EU's Transparency Directive, the FSA considered whether to go further by extending the major shareholding disclosure regime to CFDs. The FSA decided instead to conduct a further analysis of the merits of an extension, and has now proposed a new disclosure regime for reporting shareholdings. Synthetic interests in a UK-listed company's shares will soon be subject to the same ownership reporting regulations, with a consequent impact on hedge funds and the equity derivatives businesses of banks.

Originally, the FSA's consultation paper (issued in November 2007) proposed two possible options. Option one, which the FSA hinted would not be adopted, was to leave the existing regime as it was. Option two, which initially seemed to be the FSA's preferred compromise between the views of the red and the blue corners, was for the holder of a cash-settled long position in shares to aggregate these interests with any actual shares or voting rights it may hold for disclosure purposes, unless certain safe harbour requirements were satisfied. These requirements included that under the terms of the instrument, the holder is precluded from exerting any influence over voting rights and states that it does not intend to acquire the shares.

However, the new policy adopted by the FSA is a modification of the original option

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three approach to disclosure laid out in its consultation paper. The new disclosure regime will require the aggregation of CFDs with holdings of shares for the purpose of the existing disclosure thresholds under the DTR.

It will no longer be necessary for the holder of the synthetic long position to have any rights to acquire the physical shares or control voting, which was previously a prerequisite for disclosure under the DTR. Instead, hedge funds and other investors, wherever they are located, will have to disclose if they have any economic interest in the positive performance of UK-listed shares above the specified thresholds.

However, the FSA accepted that there should be certain exemptions for derivatives dealers, for instance where they hold a synthetic long position by virtue of having written a synthetic short position. This exemption was felt to be warranted on the basis that requiring disclosure by the dealer in such circumstances would not provide any useful information about corporate control.

This policy statement now aligns the DTR more closely with the UK's Takeover Code which, since 2005, has required disclosure by the holder of a long CFD position on 1% or more of the shares of a public company subject to a takeover offer.

A detailed feedback statement will be published by the FSA in September this year, together with draft regulations which will be open for drafting comments from interested parties. The regulations will be finalised by February 2009, and are likely to come into force no later than September of that year. Equity derivatives traders have just over a year to get their systems and procedures in place.

The broader picture

There are broad implications for the derivatives market in the UK and beyond. UK-listed companies, and the general investment community, have welcomed the new policy. It provides protection from secret stake building. The downside is for economic investors: they will have new

administrative burdens to comply with. Not only will this affect activist hedge funds, as in the CSX case, but also those with a pure economic exposure to UK-listed equities. In addition, equity derivatives dealers will be concerned to see how the wording of the carve-outs ends up, and Isda has already commenced work on some suggested draft language to propose to the FSA.

But how useful is this information to UK companies? Arguably, it gives them more information than they need – perhaps an additional distraction in the life of a compliance-heavy listed company? Moreover, it will be difficult to establish which disclosing parties are pure economic investors and which are quasi-shareholders and will therefore tell them little of the intentions of the investing parties. At least at the outset, it is likely that the information disclosed on holdings will be confusing and duplicative as there is likely to be more than one disclosure in respect of the same share – one in respect of the share itself and at least one other in respect of a synthetic long position on that share. There could, in theory, even be disclosure of CFD positions in aggregate in excess of 100% of the shares, since a CFD writer is not compelled to acquire the shares as a hedge.

And what of the SEC? It will be interesting to monitor US developments in light of the CSX case. Of course, the CSX court decision may be regarded as confined to the facts of the case. But in the absence of further US regulatory guidance, it is difficult for holders of synthetic long positions in US shares to know exactly when they are considered to have beneficial ownership that requires disclosure.

Certainly, despite its drawbacks, the new UK position provides more clarity regarding disclosure of investments in UK-listed stocks than the CSX case has done for the US market. Time will tell whether the SEC adopts the same approach as the FSA towards greater decisiveness on transparency and disclosure.

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