Hunton & Williams

Client Alert

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Authors

James Green
+44 (0)20 7220 5788
jgreen2@hunton.com

Christopher Raggett
+44 (0) 20 7220 5769
craggett@hunton.com

Additional Contacts

Martin Thomas
+44 (0)20 7220 5760
mthomas@hunton.com

Paul Tetlow
+44 (0)20 7220 5780
ptetlow@hunton.com

Dearbhla Quigley
+44 (0)20 7220 5709
dquigley@hunton.com

Charles E. G. Ashton
+44 (0)20 7220 5765
cashton@hunton.com

Danny Heathwood
+44 (0)20 7220 5776
dheathwood@hunton.com

Richard Jordan
+44 (0) 20 7220 5767
rjordan@hunton.com

Jennifer Lovesy
+44 (0)20 7220 5753
jlovesy@hunton.com

London Office
30 St Mary Axe
London EC3A 8EP
United Kingdom

FSA Forces Disclosure of Contracts for Differences

Changes to the Disclosure and Transparency Rules ("**DTRs**") were brought into effect on 1 June 2009; these changes have implemented an enhanced disclosure regime for listed companies. The amendments, as with the previous regime, apply to any company on the Official List of the London Stock Exchange which has the UK as its home member state and to UK companies whose shares are admitted to trading on AIM. The changes do not apply to non-UK issuers.

The Previous Regime

The previous regime, which was set out in DTR5, required that any person who held shares, or financial instruments giving the right to acquire shares, in an applicable company must disclose such shareholding where it went above or below 3 percent and every whole percentage thereafter. This applied only to any direct or indirect interest in the "real time" holding of the shares. The objective of the regime was to create transparency in the market and discourage opaque stakebuilding which could undermine shareholder confidence and value.

The New Regime

The changes maintain the thresholds at which disclosure is required but extend the disclosure obligation to include financial instruments "having a similar economic effect" to shares or other qualifying financial instruments, specifically long positions held via contracts for difference ("**CFDs**").

Background

A CFD is a contract between a seller and a buyer pursuant to which one will pay to the other the difference between the current value of the share and its value upon exercise of the contract. If the difference is positive, the seller pays the buyer and if the difference is negative, the buyer pays the seller. A long position held via a CFD indicates that the buyer believes that the share price will increase and may eventually lead to his holding the share. As such, the owner of a CFD in a company's shares has an economic interest in that company, without direct ownership.

The FSA, in its consultation in November 2007, indicated its concern that CFDs could be used to influence corporate governance and enable covert stakebuild-ing. One high-profile example of this was Mike Ashley's use of CFDs to build his stake in Blacks Leisure Group plc, the outdoor clothing and equipment chain, prior to his takeover bid which was announced in February this year.

The potential for such actions prompted the FSA to assert that "potential market failures could occur from using CFDs on an undisclosed basis to influence corporate governance and build up stakes in companies". Their concerns were so grave that the new regime actually goes further than that upon which they consulted, because CFDs and other synthetic shareholdings will be aggregated with the actual shareholdings rather than being treated separately. Further, there are only limited exemptions for CFD intermediaries.

However, the FSA's approach and the new regime have not met with widespread approval, particularly from hedge funds which often use CFDs because they do not typically attract stamp duty. Many fear that the steps taken by the FSA are less to do with transparency and more to do with appeasing the Government's criticism of speculative activity taken by bankers (in a similar vein to the steps taken to curb the abuse of short positions towards the end of last year).

Practical Effects

By forcing disclosure of intangible holdings, the FSA has closed a loophole through which institutions could covertly build stakes and influence corporate governance.

However, opinion is divided as to what this will mean in practice. Larger institutional investors will be required to watch their derivative holdings more closely and must be particularly wary given the FSA's warning, in January 2009's issue of "LIST!", that it intends to start taking public disciplinary action for breaches of DTR5. Smaller retail investors or individuals are less likely to be affected because they would rarely trade high enough volumes to be of relevance to the rules.

In any event, companies should be prepared for an increase in the number of dealing disclosures they receive and should remind themselves of their obligations under DTR5, which requires that Official List companies notify an RIS by the end of the next trading day following receipt of the notice and that AIM companies make the same notification by the end of the third trading day.