New FSA rules on disclosure of interests in UK companies

The FSA’s new rules on “Disclosure of Contracts for Difference”, which come into force on 1 June 2009, will considerably extend the scope of the disclosure regime that applies to interests in UK companies. In this context, the term “contract for difference” or “CfD” is used by the FSA as shorthand for a much wider range of economic interests, including:

- convertible bonds
- warrants
- nil paid rights
- cash-settled options
- certain investments in baskets of securities
- total equity return swaps and other contracts for differences.

All of these fall under a new umbrella definition of financial instruments which are referenced to the shares of a UK issuer and have “similar economic effects” to instruments giving a right to acquire such shares.

This note considers the impact of these new rules on issuers and investors.

Background

The existing rules on disclosure of interests in companies’ shares are based on the EU Transparency Directive and contained in DTR 5. They require disclosure of direct and indirect control of voting rights attached to shares and certain “qualifying financial instruments” - essentially options or other derivatives that give the holder the contractual right, at his option alone, to acquire existing issued shares in the company - so excluding, for example, cash-settled derivatives, convertible bonds (which relate to unissued shares) and interests under a put option.

The FSA began consulting on changing the rules in November 2007, in order to increase transparency in the market about the levels of voting rights and corporate control that can effectively be exercised by persons holding derivative instruments which do not give rise to a disclosable interest under the Transparency Directive. A policy statement setting out the final rules was published in March this year, with the effective date of the rules accelerated to June - it had previously been stated that they would not come into force until September. On 8 May 2009, the FSA issued a set of Q&A on the new rules to assist market participants’ understanding of the new rules (the “Q&A”). Click here to view the Q&A.

The new rules are based on the premise that derivative instruments:

“may give the holder the potential to gain an economic advantage in acquiring, or gaining access to, the underlying shares. For example, that result may occur because of the likelihood that the counterparty will have hedged with the underlying shares or with an instrument that may give access to those shares”.

The effect of the new rules is to extend the UK disclosure regime, making it more difficult for investors to build significant undisclosed economic stakes in UK-listed companies using cash-settled derivatives. In addition, by reaching beyond the requirements of the Transparency

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1 DTR 5.3.3G(2)(a)
Directive, the new rules will make the UK regime more onerous than those of many other EU member states in relation to disclosure of these type of positions.

These rules do not address short positions - short selling is the subject of a separate consultation process by the FSA following the disclosure requirements and temporary bans on short selling of stocks of UK financial sector companies that it introduced on an emergency basis last year. A discussion paper (DP09/1) on short selling was published in February 2009.2

In addition to the DTR requirements, the UK Takeover Code operates a disclosure regime for dealings in offeror and offeree securities during an offer period. Any person who holds 1% or more in such securities must publicly disclose any dealings during an offer period.3 This 1% threshold includes any long position held through derivatives and options, whether physically or cash settled. Where a person required to make such disclosure also has a short position, full details of that short position must also be disclosed. Disclosure does not, however, apply to a recognised intermediary4 acting in a client serving capacity.5 The Takeover Panel is currently consulting on extending its rules on disclosure of dealings in offeree and offeror companies to require interests of 1% or more in such companies to be disclosed, regardless of whether the holder deals during the offer period.

Application of the new rules

From 1 June 2009, long CfD positions6 and holdings of other financial instruments having a “similar economic effect” to (but which are not) a qualifying financial instrument will become disclosable.7 Qualifying financial instruments are, broadly, financial instruments that give a legal right to acquire (on the holder’s 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. The Q&A state that 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.

As indicated above, a broad range of instruments will be caught. The FSA has deliberately avoided employing a legalistic approach to the definition of what is disclosable in order not to encourage the creation of instruments or products designed with a view to avoiding disclosure.

In the consultation phase, the focus was on cash-settled derivatives, including CfDs and options. It was only in its March 2009 policy statement, published with the final rules, that the FSA stated that it would regard physically settled instruments such as convertible bonds and warrants as caught by the new rules. These are not caught by the existing rules, which only catch voting interests in already issued shares. However, the FSA regards them as having a similar economic effect to

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2 The closing date of the consultation in DP09/01 was 8 May 2009.
3 Rule 8.3(a) of Takeover Code.
4 A recognised intermediary is that part of the trading operations of a bank or securities house which is accepted by the Takeover Panel as a recognised intermediary for the purposes of the Takeover Code.
5 Unless the recognised intermediary is an exempt principal trader connected with the offeror or offeree (in which case disclosure under Takeover Code Rule 38.5 is required) or is an associate of the offeror or offeree (in which case disclosure under Takeover Code Rule 8.1 is required).
6 Financial instruments will be disclosable if they create a long economic position on a gross basis - i.e. short positions cannot be netted off.
7 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.
qualifying financial instruments, so holdings of convertible bonds and warrants will be disclosable from 1 June 2009.

By the same token, interests in nil paid rights will also be disclosable under the new rules. This was confirmed by the Q&A which state that nil paid rights would not be disclosable until all conditions beyond the control of the parties, including any necessary shareholder approvals, have been satisfied. In practice, the last condition beyond the control of the parties in this context will be admission of the rights to listing and trading, so it is at this point that they would become disclosable.

The FSA is understood to be considering its position regarding underwriting commitments. However, applying the same logic as the FSA is applying to nil-paid rights, an underwriter’s interest is conditional until the amount of underwriting “stick” is known, so on this basis should not give rise to any disclosure until that time. It remains to be seen whether the FSA will come to the same view.

Disclosure threshold

The threshold for disclosure is 3% of total voting rights with further disclosures at increments of 1% above that. Holdings of “similar economic effect” instruments must be aggregated with any holdings of shares or qualifying financial instruments in calculating whether the 3% threshold is reached.

Basis for calculating interests

The new rules provide for disclosure of financial instruments (other than qualifying financial instruments) on a “delta adjusted” basis. This means that rather than disclosing by reference to the full notional number of shares underlying the relevant instrument, disclosure should be made by reference to the delta of the relevant instrument.

The delta represents the number of shares that an option writer would need to hold in order to perfectly hedge its exposure under the derivative. That proportion varies over time as the price of the underlying share changes and the time to expiry shortens. So, for example, an underwater option will not be hedged to the same extent as one that is highly likely to be exercised. The option holder may therefore have to recalculate its delta adjusted holding on a daily basis in order to determine whether a disclosure is required.

A simple CfD would normally have a fixed delta of one, as it perfectly mirrors a change in the underlying share price. The holder of the CfD would therefore have to disclose an interest in the full number of shares to which the instrument is referenced. On the other hand, for an instrument with a delta of 0.5 on a particular day, the number of shares disclosable would be half of the number of underlying shares referenced to that instrument. As noted above, the proportion or “delta” may vary over time. Therefore the delta adjusted holding required to be disclosed may equally vary, even though no further transaction in the relevant instrument may have occurred, and routine monitoring of the position will be required.

The FSA favours disclosure on a delta adjusted basis as this represents the potential shareholding which the holder of the instrument may be taken to have implied access to. In the FSA’s view this

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8 Applying DTR 5.1.1R(4).
9 Instruments that are disclosable under the existing rules, such as physically settled options, are unaffected and will continue to be disclosable on a nominal basis.
10 This is also in line with the short selling rules which require disclosure on a delta adjusted basis.
avoids misleading the market by more accurately reflecting the holder’s real economic exposure to the underlying shares.

During the consultation process, a number of respondents argued that holders may face practical difficulties in calculating their disclosable holding on a delta basis. Therefore, the FSA has stated that it will allow reporting on either a nominal or a delta adjusted basis for a transitional period to 31 December 2009, after which disclosures should be made only on a delta adjusted basis.

The denominator to be used in calculating disclosable interests will remain in all cases the issued share capital of the company. This applies even in the case of instruments such as warrants and convertible bonds, where voting rights will only be exercisable when the underlying shares are issued, so that arguably disclosure against the enlarged, post-dilution share capital would be more appropriate.

Disclosure against the existing issued share capital would seem to be particularly anomalous in the case of nil paid rights. An existing shareholder holding 5% of a company’s share capital in a company making a 3 for 1 rights issue could have to disclose as though he had quadrupled his holding on issue of the nil paid rights (by adding 3 new shares for each existing share he holds) to 20% (subject to any delta adjustment). If he took up his rights in full, so maintaining his percentage holding in the enlarged capital, he would presumably have to make a further disclosure once the new shares had been issued to show that his holding had “gone down” to 5% again.

The table in the Appendix to this note sets out examples of difference types of instruments and the basis on which disclosure will be required.

**Exemptions**

**Investments in baskets or indices**

A financial instrument referenced to a basket or index of shares will not be treated as disclosable unless (i) the company in question’s shares in the basket represent 1% or more of the class in issue or 20% or more of the value of the securities in the basket or index or both; or (ii) the use of the financial instrument is connected to the avoidance of notification.

**Client-serving transactions**

An exemption is available for CFD transactions executed in a client-serving capacity where CFD writers are acting as intermediaries and providing liquidity (e.g. where a CFD writer writes a short CFD for a client, by virtue of which it takes a long CFD position itself). In such a circumstance, the long CFD position would not be disclosable by the CFD writer as the purpose of the transaction is not to influence voting or to build a stake in a company. The exemption, which is intended to be similar in nature to the Takeover Code exemption from disclosure for recognised intermediaries, is not available for a firm’s own proprietary business.

This exemption may be used by “client-serving intermediaries” i.e. any financial institution or bank authorised under MiFID or the Banking Co-ordination Directive, or any third country investment firm, to deal as principal, in a client-serving capacity, in CFDs, and to carry on any relevant

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11 Where firms report on a nominal basis during this period, the FSA will, in addition, require the disclosure of 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.

12 This is required to be announced by the company on a monthly basis under DTR 5.6.

13 This exemption does not appear to be available in relation to transactions in the shares themselves or in physically-settled instruments covered under the existing rules. However, such hedge positions may benefit from the existing trading book exemption (up to 5%).
business connected to such dealing. Various other conditions in relation to systems, controls and
certifications must be satisfied.

Trading book

Instruments held within the trading book will be able to benefit from the existing exemption
contained in the DTRs i.e. holdings that do not exceed 5% and are held on the trading book can
be disregarded. Stock held as part of a hedge can also benefit from the trading book exemption up
to the limit of 5%. This exemption is designed to avoid unnecessary burdens for firms who have
positions in shares and financial instruments which are held for resale and/or are taken on by the
firm with the intention of benefiting in the short term from differences between their buying and
selling prices or from other price or interest rate variations - not because of an interest in corporate
control. The person seeking to benefit from the exemption must not exercise the voting rights or
intervene in the management of the issuer.

Market making

The market making exception would appear from the revised rules to be limited to shares (and
therefore not cover financial instruments with a similar economic effect). However the Q&A is not
clear on this point.

Implications of the rules for issuers and investors

The new rules are intended to give the market better visibility over who is potentially stakebuilding
in UK companies. This will be particularly welcomed by issuers who have been approached by
investors who have claimed to have large interests through CfDs or similar instruments; issuers
have previously had no way of verifying the extent on such an investor’s stake.

The impact of the new rules will be seen immediately after 1 June 2009, when the rules come into
force. The Q&A confirm that interests in “similar economic effect” financial instruments, aggregated
with those in shares and qualifying financial instruments that would lead to a disclosure threshold
being reached or exceeded, must be disclosed as though the threshold had been crossed on 1
June 2009, even if no new dealings have taken place.

There may need to be an education process for company secretariat and investor relations
departments as they familiarise themselves with the concept of delta adjusted disclosure. To
ascertain the level of an investor’s holding in, say, a class of convertible bonds, they would need to
extrapolate from the delta adjusted disclosure. While market information providers may make
available delta values for some types of security, for example, traded options, this information may
not always be available on a standardised basis. The implications of disclosure on a delta adjusted
basis may need to be explained to the press and to less sophisticated investors. Similarly, issuers
and investors will need to be careful to avoid any confusion that may arise from disclosure of nil
paid rights, and other interests in unissued shares, against undiluted share capital.

Investors (such as hedge funds) which typically invest in convertible bonds and hedge their long
position by short selling the underlying shares may find that they are obliged to make disclosure of
both the gross long and the short positions they hold under DTR 5 and the short selling disclosure
regime, as these regimes operate independently of each other.

The rules apply only to UK-incorporated companies with shares listed on a regulated or a
prescribed market (including companies quoted on AIM). They do not apply to non-UK companies
even if their primary listing is in the UK. This may cause some confusion in the market since non-
UK companies with a primary listing are typically seen as being subject to the same rules as UK
companies - and even if this is not the case the non-UK companies may opt in to UK standards: for
example, some have provisions in their Articles requiring disclosure of shares at the thresholds that apply for UK companies under DTR 5 - such provisions would, however, have little impact on CfD holders, who would not be bound by the Articles unless they were also shareholders.

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Appendix

This table sets out for various types of financial instrument the basis on which disclosure will normally be required under DTR from January 2010, when the transitional period, during which disclosure on either a delta basis or a nominal basis will be permitted, expires.

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Disclosure basis</th>
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<tbody>
<tr>
<td><strong>Qualifying financial instruments</strong> <em>(Note 1)</em></td>
<td></td>
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<tr>
<td>Call option (with physical or cash settlement at holder’s discretion alone)</td>
<td>Nominal <em>(Note 2)</em></td>
</tr>
<tr>
<td>Future purchase</td>
<td>Nominal</td>
</tr>
<tr>
<td>Exchangeable bond (i.e. with right to convert into existing shares at holder’s discretion)</td>
<td>Nominal</td>
</tr>
<tr>
<td><strong>Other financial instruments with similar economic effect</strong> <em>(Note 3)</em></td>
<td></td>
</tr>
<tr>
<td>Contract for difference</td>
<td>Delta <em>(Note 4)</em></td>
</tr>
<tr>
<td>Call option (cash settled, or physical/cash at writer’s discretion)</td>
<td>Delta</td>
</tr>
<tr>
<td>Convertible bond</td>
<td>Delta</td>
</tr>
<tr>
<td>Warrant</td>
<td>Delta</td>
</tr>
<tr>
<td>Nil paid rights</td>
<td>Delta</td>
</tr>
</tbody>
</table>

**Note 1:** Qualifying financial instruments are those in respect of which disclosure is currently required in accordance with the Transparency Directive.

**Note 2:** Nominal disclosure basis means disclosing the full number of shares to which the instrument relates.

**Note 3:** Other financial instruments with similar economic effect are those for which disclosure is required for the first time from 1 June 2009.

**Note 4:** Disclosure on a delta adjusted basis is defined in DTR 5.8.2R as disclosure: “in relation to the underlying shares referenced, only in the proportion which is equal to the delta of the instrument at any particular point in time”.

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