

12 February 2008

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Policy – Primary Markets
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Sent by email to cp07_20@fsa.gov.uk

Dear Mr Cottee

Consultation paper 07/20: Disclosure of contracts for difference

RD:IR would like to thank the FSA for the opportunity to comment on the above consultation paper.

General comments

While, we are appreciative of the FSA's commitment to investigate disclosure of long CfD positions, and the work it has conducted in this regard over the past twelve months, we are not convinced that the two options proposed in the consultation will meet the concerns of listed companies in the UK and prevent the market failures identified.

RD:IR has consistently argued that improved transparency of ownership can only enhance the relationship listed companies have with their owners, leading to improved dialogue and understanding, greater market efficiency and reduced volatility. The growth in the number of CfDs written has grown exponentially over the last six years as shown in Chart 1 on page 13 of the consultation paper, which suggests 700% growth over the period. Clearly the benefits of CfDs – stamp duty exemption, speed of settlement, increased leverage, increased liquidity etc – make them attractive investments and, therefore, this rapid growth is likely to continue.

The resulting, opaqueness, in issuing companies' share registers means it is frequently unclear who owns or can influence company shares and, there is little doubt, CfDs are used to both stake build and influence votes, albeit in a minority of cases. Lack of transparency also makes it impossible to manage efficiently the time of investor relations professionals and executive directors, who spend a significant proportion of their time engaging with

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their shareholders, and who need to target their communications strategies effectively as part of good corporate governance¹ and the efficient management of their companies.

The current Major Shareholder Notification Regime, under chapter five of the FSA's Disclosure and Transparency Rules, reveals a relatively small proportion of direct shareholdings above the 3% threshold, on average around three to five shareholders owning above 3% of the issued share capital appear on a company's share register. It is likely the vast majority of CfD transactions fall below the 3% threshold and will not require any form of disclosure. However, when large unidentified positions are held through CfDs, this inevitably results in confusion in the market, press speculation, and share price movements. This situation can only deteriorate without an effective regime for disclosure of CfD positions above the 3% threshold, and with the continuing increase in CfD transactions.

The premise of the FSA's methodology, within Option 2, is to identify those CfDs which are closed out with the underlying stock, and/or CfD writers vote on behalf of CfD holders where they hedge their positions with the underlying stock. While, in theory, this should negate some of the above concerns, in practice it is hard to see how it could be enforced for the following reasons

- a. A CfD which is closed with delivery of shares or provides access to voting rights gives the holder an interest already disclosable under the current regime. The fact that both of these practises currently appear to occur informally, thereby avoiding the disclosure requirement, indicate that they would continue to so occur under the proposed new regulations.
- b. If a CfD is written and hedged with the underlying shares, the CfD holder has prior knowledge of the sale, and the availability of a substantial position. The owner of the CfD can, in theory, execute a buy order at the same time as the sell order from the CfD writer, purchasing the underlying stock. For the duration of the CfD they would have fallen within the safe harbour and allowed to remain 'silent'. Stake building by stealth would remain possible.
- c. It is unclear how the FSA could prove intent to mislead or take enforcement action against a CfD writer or holder. In any case, it is unclear how undertakings to the effect that the CfD holder is not interested in obtaining shares or influencing votes could continue to hold when the CfD came to an end. Investors are free to change their minds and the fact that they once held a CfD cannot be made to preclude them from seeking to purchase the shares in the future. The terms of a CfD cannot bind an investor after the CfD has terminated and so there would be nothing to stop an investor buying the shares direct from the former CfD writer.
- d. In the case of a company serving a 's793 equivalent' notice on a CfD holder on reasonable grounds which reveals a significant holding, there is no onward obligation for notification by the CfD holder when the holding moves through a threshold unless the company makes another such request on reasonable

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grounds. This could lead to market confusion and asymmetry of information. For example, whereas there may be significant press speculation that a stake has been built, there may subsequently be no indication of a holding being sold, giving the company no reasonable grounds to serve an appropriate notice, and no indication of timing as to when to do so. Furthermore, in those cases, which frequently occur, and which are most in need of the proposed process, where there is obviously a large CfD position, though the issuer has no reasonable grounds to believe that any particular investor is the CfD holder, the process becomes ineffective.

In the case of Option 3, the levels of thresholds proposed, and the proposal that CfD holdings should not be aggregated with direct holdings, would allow an undisclosed stake of up to 8% to be built through a combination of a directly owned holding of 3% and a CfD holding of 5%. We believe this level is unacceptable.

We would, therefore, be supportive of the IR Society's proposal that a regime similar to the successful Takeover Panel rules, be applied generally ie economic interests in shares such as CfDs and similar instruments should be disclosed as if they were shares, and that these interests be aggregated with shares including voting rights for the purposes of disclosure. Hence an aggregated position of 3% and above would be disclosable in line with the existing rules under chapter five of the Disclosure and Transparency Rules. This would be a simple, cheap and effective method of bringing ownership via CfDs into line with the current disclosure regime.

¹ 2006 Combined Code: Relations with shareholders

D.1 Dialogue with Institutional Shareholders

Main principle

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring a satisfactory dialogue with shareholders takes place.

Supporting principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman (and the senior independent director and other directors as appropriate) should maintain sufficient contact with major shareholders to understand their issues and concerns.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

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Specific consultation questions

Given our comments above, we have restricted our answers to those questions most relevant to our position.

Q1 Do you agree that we have identified the concerns of issuers and market participants correctly?

The FSA has outlined the main concerns of issuers and market participants within its consultation paper and has obviously gone to some lengths to consult widely. We would welcome further consultation and consideration of the informal communication/agreement between CfD writers and holders regarding the post termination of CfD sale of shares held as hedge. CfD Transparency of ownership is of great importance to issuers and is fundamental to their communications strategies and their relationships with shareholders. We completely concur with the Hedge Fund Working Group's statement, "The HFWG acknowledges that companies have a right to know who owns them or who has an ability to obtain significant voting power."

Q2 Do you agree that we have identified the right market failures? If not, what other potential market failures do you think we should consider?

On the whole, we believe the consultation paper has covered the right market failures. However, further consultation could have taken place with listed companies on the issues they face when ownership is not transparent among significant holders.

Q3 Do you agree with our analysis of the evidence set out in this chapter? Is there further evidence that you think we should consider?

It would be helpful to have a better understanding of how many CfDs are written over the 3% threshold, and how the writers and holders of CfDs perceive the increase in use of such positions going forward. It would also have been helpful to clarify, how many announcements made under Takeover Panel Rules, relate to derivative positions of 3% and over. In accordance with the IR Society, RD:IR believes the preferred alternative to Options 2 and 3 would be a regime similar to that of the successful Takeover Panel Rules, applied generally, i.e. economic interests in financial instruments such as CfDs being disclosed as if they were shares and aggregated with direct interests. We were disappointed more analysis was not conducted around this alternative option.

Q4 Do you agree with our conclusion that action should be taken to increase disclosure of CfDs.

RD:IR is firmly of the opinion that increased disclosure is required.

Q5 Do you agree that our proposed definition of comparable financial instrument, taken together with our guidance on 'similar economic effect', will effectively capture all instruments that could potentially otherwise be used to build stakes or exert influence on an undisclosed basis? If not, are there any instruments that a)

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should be caught but will not be, or b) will be caught but should not be?

RD:IR originally proposed that the **Takeover Panel definition** “*any option in respect of, or derivative referenced to, securities.*” be used. However, we can see no practical difference in using the proposed definition instead and so we do agree that the proposed definition will effectively capture all instruments that could potentially otherwise be used to build stakes or exert influence on an undisclosed basis. We note, however, the constant innovation in financial instruments and would urge the FSA to incorporate some provision for widening the definition as may become necessary. We note the text of s820 of the Companies Act 2006 which states that ‘interest’ in shares “*includes an interest of any kind whatsoever in the shares*”. The courts have described this wide definition as being designed to “Counter the limitless ingenuity of persons who prefer to conceal their interests behind trusts and corporate entities” (re TR Technology Investment Trust plc [1988] BCLC 256 at 261). We would welcome consultation on whether CfDs could be explicitly brought within the Companies Act definition of ‘interest’.

**Q6 Do you agree that CfDs not complying with a safe harbour should be disclosed?
Q7 Do you agree with the specific conditions we have proposed for the safe harbour, and that, as necessary, they can practicably be incorporated into the agreements between the parties to a CfD contract?**

In accordance with our general comments, RD:IR believes the safe harbour proposal, as it relates to Option 2, is neither practical, effective nor enforceable.

Q8 Do you agree that there should be a ‘notification to issuer on reasonable request’ provision?

Q9 Do you agree with the proposed guidance on what constitutes reasonable grounds, and that issuers should be required to include these in the notification request?


Again, in line with our general comments, we do not believe the ‘notification to issuer on reasonable request’ provision within Option 2 to be practical or enforceable and potentially creates another layer of confusion in the market.

Q10 Do you agree with our proposed approach to aggregation and thresholds for Option 2? We wholeheartedly disagree with the aggregation and thresholds for Option 2 as we believe they effectively raise the threshold of disclosure to 8%. This provides an incentive for an investor who wants an 8% stake, but would prefer to remain anonymous, to use CfDs whereas under the current regime they would simply directly own 8% and disclose. We feel that given the ineffectiveness of the proposed safe harbour rules and the proposed ‘notification to issuer on reasonable request’ process, the undisclosed purely economic CfDs pose significant potential for lack of transparency in the market.

Q12 Do you agree with our analysis of the relative costs and benefits of Option 2 and Option 3?

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While appreciating this is hard to quantify, there does seem to be some confusion as to the basis of the underlying premise. Annex 1 suggests that estimates of costs are based on the thresholds contained in the Transparency Directive, and the increase to the number of MSN announcements necessitated by Option 3 to be around 20-50% based on the Swiss regime, and figures taken from the Takeover Panel regime. However, the question asked in the PwC survey in Annex 4 asks,

“If the existing disclosure rules were expanded to include a requirement to disclose economic interests at the same levels as those currently required by the Takeover Panel rules on voting interests, what would you estimate the incremental cost of this be for your business”.

The responses, therefore, surely must be misleading as Takeover Panel Rule 8.3 (a) requires public disclosure in 1% or more of any class of relevant securities. Hence there seems to be a combination of threshold levels assumed in reaching what seems to be a very high estimate of costs for implementing Option 3. It would seem sensible to ascertain an estimate of the number of CfDs written above 3% of the issued share capital of a company to come to a more realistic conclusion. The cost of disclosing CfD positions during offer periods does not appear to have had a negative effect on the number of CfDs written during periods of increased disclosure as the number of CfDs written increases during these events. It would seem increased disclosure has no negative impact on trading volume.

Q13 Which option do you think would best address the identified market failures?

As discussed in our earlier comments, neither Option 2 or 3 adequately addresses the identified market failures; we would support the IR Society’s views on an alternative approach and would welcome further consultation.

We look forward to the outcome of this consultation paper, and to continued discussions and we would encourage to FSA to contact us with any questions or for any explanation of anything in this response.

Yours sincerely



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About RD:IR

RD:IR is a full-service Investor Relations consultancy based in London, that is dedicated to providing the highest quality financial intelligence and capital market insight to public companies and their advisors.

RD:IR provides a wide range of IR services to IROs and company senior management in the UK, and internationally, which are all based on the underlying principle of achieving fair value of company's shares through the most effective marketing of their equity. RD:IR also offers a wide range of quantitative and qualitative research processes to participants in the global capital markets which help clients understand better the worlds in which they operate.

RD:IR is retained by over 450 UK and international public companies, and act for a wide range of financial intermediaries and organisations including stockbrokers, financial PR agencies, investment banks and a number of leading financial newspapers and magazines.

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