

Disclosure of Contracts for Difference

Submission by The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the FSA's decision to require disclosure of Contracts for Difference (CfDs) and other similar derivative instruments. The key aspects of the proposal – notably the threshold at which disclosure will be required and the aggregation of CfDs into a general regime alongside shares and options – will address identified market failures in a proportionate and effective manner. CfD disclosure will also have supplementary benefits by creating transparency which supports investors' confidence in the standards which apply in UK markets.

Notwithstanding the AIC's overall support for the proposals, there are some issues raised by their current formulation which require careful attention to ensure that the full benefits of the policy are achieved.

Timetable for introducing CFD disclosure

The FSA has identified specific market failures and the means to address them. Until CfD disclosure is introduced the potential for these market failures to arise persists. Arguably the chances of problems arising in relation to voting rights and corporate control are more pronounced in the volatile conditions which characterise the current operation of the stock market.

By way of example, we note the recent developments vis-à-vis Porsche's shareholding in Volkswagen. At one point in October 2008 Porsche held nearly 75% of the other carmaker's shares. It had acquired a significant proportion of this stake via instruments very similar to CfDs without making disclosures while this interest was being built. This created issues for other market participants and raised questions about the operation of the German market. While an identical situation could not arise in the UK (notably because of the Takeover Panel rules) this example demonstrates that, in practice, substantial stakes in companies can be built via CfDs. It also shows that this can have broader consequences which may harm market confidence. The FSA should not run the risk of allowing an equivalent situation to arise in the UK by delaying the introduction of CfD disclosure for any longer than necessary.

The current timetable will see the final CFD rules made in February 2009. The FSA's proposal is that these should be brought into force in September 2009. It is suggested that industry participants will need this delay to put systems in place to ensure they are able to comply with the new regime. We find it very difficult to believe that a six month timetable is required.

When the FSA decided to introduce disclosure of short positions held in companies which are undertaking rights issues it gave the market seven days to

prepare for the disclosure requirement and implement systems changes. As far as we are aware, this very challenging deadline was successfully met by relevant industry participants. This was despite the fact that the market had no warning of this change. In contrast, CfD disclosure has been the subject of debate for a significant period. The intention to introduce a general disclosure regime was announced in July 2008 and draft regulations (which we envisage will be substantially unaltered when they are introduced) were published in October 2009.

Given the high levels of market awareness about the introduction of CfD disclosure the AIC cannot accept that 6 months will be required to make relevant systems change. Our strong **recommendation** would be for the rules to come into force no more than 3 months, or earlier if possible, from the laying of the finalised regulations.

Consultation questions

Q. 1 Do you agree that our approach to definition and scope will be a workable solution that will give the market sufficient certainty while restricting attempts to avoid disclosure?

Questions relating to the scope of the disclosure regime falls into two categories – the type of instruments which need to be disclosed and the issuers which will be affected.

Disclosable instruments: The AIC agrees that the rules should require disclosure of CfDs and other instruments with a similar economic effect. Requiring disclosure of CfDs only would simply raise the prospect of slight alterations being made to instruments to avoid the need for disclosure while achieving the same overall effect for the purchaser of that instrument.

The AIC also agrees that the calculations of whether or not instruments need to be disclosed should be made on a ‘delta adjusted’ basis. This will provide the market with useful data and reduce the risk of confusing over-disclosure.

The regulations include guidance to help stakeholders understand their disclosure obligations. This guidance is helpful, but there is some scope for it to be improved. 5.3.3 G (iii) covers baskets or indexes of shares. It says that instruments should be disclosed when shares within the basket represent 1% of the class in issue and 20% or more of the value of the securities in the basket or index. The AIC **recommends** that the guidance should also say that disclosures should be made if a market participant holds a series of CfDs each related to a basket or index of shares, but where these taken together would give interests in shares which would breach the thresholds as outlined.

The AIC also **recommends** that the guidance be extended to include a 'general avoidance' provision. That is, it should say that disclosable financial instruments will include instruments which have been designed to avoid disclosure which would otherwise be required.

Issuers affected: The regulations currently require that CfDs referenced to 'UK issuers' are to be disclosed. The AIC strongly supports this proposal. However, while the debate has been focussed on UK issuers to date, it is not clear why disclosure has not been extended to non-UK issuers, which are currently excluded under rule 5.3.1 (1) (b) (I).

Treating non-UK issuers differently has not been previously discussed in any detail. This was not raised as a specific question in the November 2008 consultation. Indeed, we understood that the draft regulations published in November 2008 would have resulted in the disclosure of CfDs associated with the shares of non-UK issuers. It is not clear why this policy position should change and there should not be consistency between UK and non-UK issuers. This is particularly the case as consultation has resulted in the overall structure of the rules being significantly reformed to ensure they have a proportionate impact on market participants.

The DTRs let shareholders know who has a significant influence in a company through direct or indirect access to voting rights. This protects shareholders as they can see who might seek an influence over issues of corporate control and company strategy. The FSA's consultations to date have secured agreement that CfD disclosure will help protect shareholders. From the shareholder's perspective there is no reason why issues related to control and influence do not arise in relation to non-UK issuers as much as UK-issuers. Therefore, the FSA's starting point should be that, in principle, CfD disclosure should be required of all companies trading on UK regulated markets whose home state is the UK.

We recognise that the FSA may still be concerned with the overall regulatory burden created by disclosure requirements. However, there is no reason in principle why CfD disclosure should not be required on the same basis which is currently required for shares and options. It will address a potential market failure. Also, the proposed regime has been simplified and made more cost-effective by integrating it into the current disclosure regime for shares and options. Given this it is difficult to see that the cost of including non-UK issuers in the regime would have any material cost for those likely to disclose. Excluding non-UK issuers adds an element of complexity at the same time as leaving open an opportunity for the identified market failures to arise in relation to non-UK issuers.

The AIC can therefore identify no justification for not requiring disclosure of CfDs associated with non-UK issuer shares. It is concerned that such an approach could be considered where there has not been a full discussion of its implications

and it leaves scope for market failures to arise. The AIC therefore **recommends** that CfDs associated with non-UK issuer shares should be included in the disclosure regime on the same basis that shares and options are currently disclosed.

Q. 2 Do you think that our rules and guidance requiring disclosure on a delta adjusted basis would meet our objective of countering possible anti-avoidance issues and preventing over-disclosure of notional interests in cash settled derivatives?

See Q1 for further discussion on anti-avoidance and related issues.

Q. 3 Do you agree with our approach to having an exemption for client-serving transactions?

The AIC agrees that an exemption for client serving transactions is appropriate. We strongly support only making this available to firms which have certified in writing that they meet the required conditions. This will provide a strong mechanism which ensures that firms – and particular individuals – which are taking advantage of the exemption can be held to account if there is any question of abuse. In turn this will significantly reduce the likelihood that any abuse will materialise in the first place.

Requiring that the sign-off for the exemption be made at director level is also welcome. It will ensure that appropriate expertise will be devoted to assessing whether or not an exemption is suitable. It will also encourage proper internal management systems to be put in place. Requiring an annual re-application for the exemption will mean that the suitability of the exemption is regularly reviewed by the firm. All these factors will make a significant contribution to ensuring that the exemption is not inappropriately claimed or that is abused.

Q. 4. Will that exemption be effective in reducing the number of unnecessary and misleading disclosures, without significantly increasing the risk of avoidance of disclosure?

Yes. See more detailed in response to Q.3

Q.5. Do you agree that our approach to group issues is a practical and workable solution?

Yes. We agree that each company within a group wishing to take advantage of the exemption should be required to make separate applications for client-serving intermediary status. This will be an important means to prevent abuse (deliberate or otherwise) of the exemption.

Q. 6 Do you agree with our approach to applying the existing DTR exemptions to CfDs?

We are not convinced that the existing DTR exemptions should be applied to CfD positions.

Our understanding is that market makers do not customarily use a long CfD as part of their market making activities. Given this, allowing this exemption to be used for CfDs creates scope for abuse where these instruments could be inappropriately allocated to the market making function in an effort to avoid disclosure. The AIC therefore **recommends** that the market maker exemption should not be available to secure non disclosure of CfDs.

The AIC is also unconvinced that non-disclosure should be available to CfD holders where they are held in a 'trading book'. Trading activity still creates the potential for the holder to exercise control over the voting rights attached to shares once the CfD position is closed if they then acquire the related shares.

The consultation notes that, where shares are concerned, the trading book exemption can only be used if the voting rights attached to shares are not exercised. However, this mechanism has little value in the case of CfDs because the control of the voting rights would only emerge once the CfD had been closed-out. The CfD would not therefore be used to exercise influence whilst it was on the trading book but does create circumstances where such an influence could be exercised in the future and means these interests should be disclosed. The AIC therefore **recommends** that the trading book exemption should not be made available to holders of long-CfDs.

Notwithstanding our overall objections to existing exemptions being used to exempt disclosure of CfDs, we would also make a technical observation on the current construction of the rules. The glossary definition of the trading book (referred to in 5.1.3 R (4) (c)) does not currently include the required reference to the DTR.

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