Consultation Paper

07/20★★★

Financial Services Authority

Disclosure of Contracts for Difference

Consultation and draft Handbook text

November 2007

Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 12 February 2008.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2007/cp07_20_response.shtml).

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1 Executive summary

1. Overview

Background and purpose

1.1. In our March 2006 Consultation Paper on the implementation of the Transparency Directive[1] (TD), we explained that responsibility for overseeing the Major Shareholders Notification regime (MSN) would pass from the (then) DTI to us. This meant the (then) Companies Bill would give us powers to extend the regime beyond the disclosure of 'ownership' of substantial equity positions to require the disclosure of substantial 'economic interests' in shares held through derivatives such as Contracts for Difference (CfDs). We invited respondents to consider the issue of derivative disclosure with a view to a longer-term discussion.

1.2. As we noted in Policy Statement 06/11, there was no consensus among respondents on the need for disclosure. However, the majority encouraged us to investigate further. Given this, and the anecdotal nature of the evidence we had received, we undertook to carry out further analysis to explore possible market failures arising from the current position of (generally) non-disclosure, and the potential costs and benefits of addressing them. This paper sets out the results of our analysis and our proposals for addressing the market failures that we have identified.

Scope

1.3. The main focus of this paper is on CfDs. However, we are conscious of the need to ensure that any measures we introduce are framed so that they cover other financial instruments that raise the same issues. At the moment, CfDs are the instrument most widely used for holding an economic interest. The discussion in this paper is therefore presented in terms of CfDs, but this should be understood as shorthand for other derivative instruments which may have the same effect.

1.4. We are concerned here solely with CfDs referenced to UK shares admitted to trading on a regulated or other prescribed market. This includes UK shares admitted to the

1 CP 06/4 *Implementation of the Transparency Directive and Investment Entities Listing Review*.

regulated markets of UK Recognised Investment Exchanges and to UK shares admitted to the LSE's AIM market. This is the group of shares for which we implemented MSN rules that are super-equivalent to the TD. For non-UK shares, we have implemented only the minimum MSN rules.

1.5. We have not brought issues relating to a person voting equities they have borrowed within the scope of this paper. Those stock borrowing and lending issues are currently under consideration by a number of bodies, including the European Commission and, in the UK, the Takeover Panel. We shall be following these discussions closely.

1.6. This paper focuses on long CfD positions, that is CfDs where the holder gains from a rise in the underlying share price. While we recognise that not all CfDs are structured this way, it is long CfDs that may be hedged by the underlying equity, and that are most likely to provide a link to voting rights.

The CfD market and the UK regulatory framework

1.7. The CfD market in the UK has grown significantly in the last five years. Current estimates suggest that about 30% of equity trades are in some way driven by CfD transactions referenced to the underlying shares. CfD holders cite leverage, the ability to go short, the avoidance of stamp duty and anonymity amongst the prime reasons for using them.

1.8. Despite the growth in the market, CfDs mostly remain outside the regulatory framework governing disclosure. This framework exists primarily to provide to the public accurate, comprehensive and timely information about changes in major shareholdings in companies issuing shares. The current disclosure requirements are therefore referenced to direct and indirect control of voting rights attaching to a share. In the UK we have kept the previous Companies Act 1985 disclosure thresholds of 3% and every 1% thereafter in our Disclosure and Transparency Rules (DTRs). CfDs fall outside the scope of the DTRs unless specific contracts explicitly give access to the voting rights attached to shares held as hedge by the CfD writer or access to the shares themselves on expiry of the contract.

1.9. Since November 2005 the Takeover Panel has required disclosure during an offer period of long interests, including economic interest (such as CfDs and other interests arising from derivatives) of 1% or more in the securities of a target company.

Concerns of market participants

1.10. Issuers and investors have raised various concerns relating to the lack of disclosure, including:

- that the lack of transparency with respect to substantial economic interests allows the use of those interests as a means of exerting influence over, or to gain control of, the voting rights attaching to the underlying shares;
- that issuers are unable to know who has significant economic exposure to their shares, and the scope that provides for potential abuse, or misleading representation, of access to voting rights; and

- that hedge funds may outflank traditional institutional investors by using economic interests to influence companies, and that some investors may be disadvantaged by investing in a market where others may have better information, such as who holds significant undisclosed economic interests.

1.11. CfD writers and holders have been concerned that increased disclosure could make the market less efficient by introducing excessive or contradictory information. This could also damage liquidity in CfDs and therefore ultimately in the underlying equities as holders might seek to limit their holdings to avoid disclosure.

Analysis of potential market failures

1.12. In analysing these concerns further, we have identified three potential market failures which might arise from non-disclosure of CfDs, relating to:

- inefficient price formation;
- distorted market for takeovers; and
- diminished market confidence.

1.13. These failures could arise for two reasons. First, they may arise because the pure economic interests that are inherent in CfDs are not disclosed. This would be most likely to result in inefficient price formation. Second, these failures could arise if there is a link between the (undisclosed) economic interests of the CfD and the voting rights that are attached to the underlying shares (which are covered by the existing MSN regime).

1.14. We have undertaken several strands of analysis to assess whether these market failures arise in practice. These comprise:

- an evaluation of the market efficiency case for requiring disclosure of the pure economic interest of CfDs;
- a review of the literature on Major Shareholding Notification (MSN) disclosure and its theoretical impact on price formation;
- an empirical study of the actual impact of MSN disclosures on price formation;
- an extensive survey of the practices of the some of the most active CfD-writing banks and other market participants, conducted for us by PricewaterhouseCoopers (PwC) to help assess the extent to which CfDs might be substitutes for the underlying shares, and
- a study of the patterns of CfD trading inside and outside of takeover periods for selected stocks.

1.15. We have considered a number of recent cases where CfDs have, or appear to have, been used in order to gain access to voting rights or to influence companies' corporate governance on an undisclosed basis. We have also considered the assessment made by the Takeover Panel of the changes it made to its own disclosure regime in November 2005, and regulatory developments in jurisdictions outside the UK which will require greater disclosure of derivative positions.

Conclusions of our analysis

1.16. The main conclusions that we draw from this analysis are as follows.

(i) Disclosure of economic interests

1.17. Information about pure economic interests may, if disclosed, influence the pricing of the reference share. That could be the case if either (i) it was clear that holders of large CfD positions could, by virtue of their economic position, exercise similar influence over an issuer's management as the holders of votes, or (ii) the disclosure of a large position by a particular market participant was used by the market to price the shares. However, we would generally expect equity market prices to reflect information on market trades, including those in both the underlying equity and perhaps in the CfDs themselves. Overall, we conclude that the evidence that the non-disclosure of pure economic interests can create problems of inefficient price formation is mixed.

(ii) Voting rights: theory and practice

1.18. In relation to voting rights, our review of the academic evidence suggests that MSN disclosures are of value to the market. The literature suggests they are particularly important in the context of takeover situations, where lack of disclosure of significant holdings can discourage other potential bidders from entering a contest. Our empirical analysis of recent UK MSN data also finds that disclosures have an impact on prices.

1.19. In applying these conclusions to the issue of CfD disclosure, the key question is whether CfDs are in effect a substitute for shares so that disclosure of CfD positions would bring the same benefits to price formation, takeover situations and market confidence as MSN disclosures. This would be the case where:

- CfD positions 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.

1.20. The survey carried out for us by PwC suggests that the policies and practices of investment banks writing CfDs do not generally operate in these ways. But it also demonstrates that despite the stated – and implemented - policies of investment banks, holders of CfDs do sometimes approach the writers seeking to exert influence on an undisclosed basis over voting rights attached to stock held as hedge against those contracts (it should be noted that the general policy of investment banks is not to vote shares in accordance with CfD holders' wishes).

1.21. In addition it is clear to us from a number of recent cases that CfDs have been used to exert influence and/or build up stakes in companies on an undisclosed basis and that increasingly there is a general acceptance in the market that this can be achieved through CfDs.

(iii) CfD activity before and during takeover periods

1.22. Our review of trading volumes of CfDs referenced to the stock of an issuer that is the subject of a takeover bid shows that there does not appear to be a significant difference in the number of contracts written in the run-up to the offer and the number written in the one month after the offer period starts. Nor does there appear to be a significant build up of CfD activity in the months ahead of an offer period. However, the value of CfD activity does increase substantially once an offer period starts (i.e. the average size of the CfDs written goes up). On this basis, the changes the Takeover Panel introduced in 2005 appear to have addressed disclosure concerns for the most important time period.

(iv) Regulation outside the UK

1.23. There is some move towards greater disclosure of derivatives positions in some jurisdictions outside the EU, largely driven by concerns over takeover situations or the exercise of voting rights more generally. Some of these moves are too recent to draw any conclusions about their consequences. The experience of those regulators that have had disclosure regimes for some time does not suggest that disclosure of CfDs has had a negative effect on market growth or liquidity.

1.24. Taking these conclusions together we take the overall view that CfDs are not in effect a substitute for the shares on a systematic basis. But there are some instances of CfDs being used in ways which the intention of the current regulatory regime is designed to catch, and that while this only happens occasionally, it is not fully caught by the requirements of the Takeover Panel regime. Specifically, we conclude that CfDs are sometimes being used, firstly, to seek to influence votes and other corporate governance matters on an undisclosed basis and, secondly, to build up stakes in companies, again without disclosure. We have therefore decided that we should take action now to address these failures. We propose to do this through increasing the disclosure requirements on CfDs either in specific circumstances or as a general requirement.

Policy options

1.25. The options we have been considering are to:

Option 1 – Leave the current disclosure regime as it stands;

Option 2 – Strengthen the current regime by requiring the disclosure of substantial economic interests unless the holder has taken specific steps to preclude himself from exercising influence over the underlying shares; or

Option 3 – Introduce a comprehensive regime, similar to the major shareholder notification regime, which would require disclosure by all holders of substantial 'economic interests in shares'.

1.26. In considering these options, we have been guided by three key propositions:

- We are not against the use of CfDs to influence corporate actions and governance matters provided it is on the basis of disclosure (as would be the case for shares held directly);

- We do see some specific 'failures' of the current regime where lack of disclosure appears to be the underlying difficulty, but these are not systematic in nature; and
- Given these failures are not systematic, our preference should be for proportionate solutions that address as far as possible the more significant concerns and do not lead to requiring the disclosure of excessive or unnecessary information. We have decided that Option 1, as raised in PS 06/11, of maintaining the current regime unchanged, is not appropriate.

1.27. On this basis, we propose a two-part response:

– first, a clear restatement of the existing regulatory regime, which we believe will make clear the extent to which certain behaviours that are causing concern are already caught by our rules; and

– second, measures designed to achieve greater disclosure of CfD positions in those circumstances where CfD holders are seeking to influence a company's management and strategy, or seeking to use CfDs as a basis for engaging in stakebuilding. To achieve that goal, we are putting forward two separate options for consultation: a package of specific targeted measures which would strengthen the application of the existing regime, and lead to enhanced disclosure in specific circumstances (we label this 'Option 2' in what follows); and a generalised disclosure regime (which we label 'Option 3').

(i) Option 2: strengthening the existing regime

1.28. We believe we can strengthen the existing regime in a targeted and proportionate way that would deliver precise tools for issuers to use in the specific circumstances that are of most concern to them. Option 2 would deem CfDs to have access to voting rights, and therefore require disclosure unless stringent safe harbour requirements are met, namely:

- The agreement with the CfD writer explicitly precludes the holder from exercising or seeking to exercise voting rights;
- the terms of the agreement excludes further arrangements or understandings in relation to the potential sale of the underlying shares; and
- there is an explicit statement by the holder that they do not intend to use their CfDs to seek access to voting rights.

1.29. Interests in CfDs which do not meet the safe harbour would be aggregated with shares and other instruments which provide access to voting rights, and the combined total would be disclosable above a threshold of 3%, as is the case now for instruments with access to voting rights.

1.30. In recognition of the fact that an issuer may want to know of a significant CfD position, even if it currently meets the legal requirements of the safe harbour, Option 2 will in addition provide a mechanism for issuers, with similar effect to s793 of the Companies Act 2006, to 'flush out' holders of economic interests above 5% in a targeted and precise way – this threshold would operate separately to that for interests with voting rights. This should make it more difficult for a CfD holder to gain access to management on the basis of an undisclosed economic interest, and also to build a significant stake with no disclosure.

1.31. By focussing on addressing the issues surrounding the use of CfDs to access or influence voting rights we believe that market confidence generally will be enhanced. We believe that the costs of this option would not be significant.

(ii) Option 3: a general disclosure regime

1.32. The alternative approach is to introduce a regime that would require the disclosure of all economic interests above a 5% threshold held through CfDs and other derivatives. This threshold would operate separately from the threshold for shares and qualifying financial instruments. There would be no aggregation across the two sets of instruments. The scope would be consistent with the scope of requirements of the Takeover Panel regime, and as a 'one size fits all' approach would be relatively simple to comply with. The direct initial costs of Option 3 could be of the order of £20m-50m. There could also be wider indirect costs, for example to the liquidity of the market in CfDs and of the underlying equity market.

1.33. Both approaches would have the benefit of providing greater transparency for issuers and for the market at least in terms of who holds economic interest in them and therefore who their potential shareholders are. They would also potentially help reduce some of the price volatility that may be caused by information asymmetries. The balance of argument between additional measures to strengthen the existing regime and introducing a general disclosure regime is a fine one. We believe that Option 2 is proportionate and targeted, and would prevent CfD holders from seeking to exert influence over companies without disclosing their positions, either because the terms of the safe harbour would thereby be breached, or because issuers would have reasonable grounds for forcing disclosure. As we note above, Option 3 is an alternative approach to achieving the same objectives as Option 2. This option is supported by a number of stakeholders who would prefer to see a general disclosure regime. We are therefore proposing draft rules for consultation on both options. In theory it would also be possible to have a combination of Option 2 and Option 3. But we think, in practice, this would be of limited value and would cause potential confusion and greater cost. We are therefore consulting on the basis of a clear choice between Option 2 and Option 3.

Interaction with Takeover Panel rules

1.34. A key issue is how these rules would interface with those of the Panel during offer periods. We have discussed this with the Panel. Our objective is to avoid duplication of disclosure for firms. This could be achieved in two ways. Either we could state in our rules that the notification requirements do not apply if the transaction has already been disclosed pursuant to the Panel's rules or we could 'turn off' our rules when an offer period starts. Our preference is for the former, and this is the basis on which the rules for Option 2 and Option 3 have been drafted.

Outline of Paper

- Chapter 2 gives factual **market background** on the UK market for CfDs and the **current regulatory framework**, including the requirements of the Transparency Directive, Market Abuse Directive and those of the Takeover Panel;
- Chapter 3 sets out the **views of stakeholders** (issuers, investment banks and holders of CfDs) and the **possible market failures** they might raise;
- Chapter 4 summarises the **evidence for these market failures**, sets out a number of case studies, considers the approach to CfD disclosure in other jurisdictions and sets out the rules of the Takeover Panel in relation to disclosure;
- Chapter 5 sets out the **overall conclusions** we draw from the analysis we have carried out, the extent to which they highlight market failures, and, in this overall light, our **policy proposals**.

Who should read this paper?

- Investors in equity and equity derivative markets and their advisers
- Issuing companies
- Banks and their advisers
- Brokers
- Intermediaries

2 CfDs on UK Equities

2.1. In this chapter we describe some of the key features of the UK CfD market, including the key characteristics of a CfD, and the growth of the use of CfDs as a financial instrument. We also set out the current regulatory framework governing disclosure.

What is a CfD?

2.2. A CfD on a share is a derivative product that gives the holder an economic exposure, which can be long or short, to the change in price of a specific share over the life of the contract. Contracts are normally open-ended, and can be closed out by the CfD holder on demand. The contract does not give the holder either ownership of the referenced shares or any ownership rights, such as voting rights. Nor, since the contract is normally cash-settled, does it usually create any right to take delivery of the shares in place of cash settlement. However, CfD contracts usually provide for adjustments related to dividend payments and share issues (synthetic dividends and adjustments) that take place during the life of the contract.

2.3. One of the basic characteristics of a CfD is that the investor is able to take an economic exposure to a movement in the referenced share at a small fraction of the cost of securing a similar exposure by acquiring the shares themselves. CfD contracts generally require the investor to lodge an initial margin payment of no more than 5%-10% with the CfD provider. So, in a case where a 10% margin is required, an investor putting up an initial deposit of £100 may be able to enter into a CfD (long) position referenced to shares with a value (at the outset) of £1,000. However, since the writer of the CfD often hedges its risk by taking a corresponding position in the shares underlying the contract, it also needs to recover the financing charges it incurs (to support purchases that hedge a long CfD). The financing charge is typically calculated on a LIBOR + x basis.

2.4. Although entities that provide CfDs (usually investment banks) generally hedge their risk by acquiring or selling short a corresponding number of underlying securities at around the reference price, some banks may offset the risk by entering into matching derivative positions. We discuss hedging practices in more detail in chapter 3. When the parties close out the CfD, it is likely that the hedge will also be unwound. While generally the investor receives cash from or pays cash to the issuer, in the case of a

CfD relating to shares, the parties may occasionally prefer to settle the CfD physically. The investor would then take delivery of the shares that had been held as a hedge by the CfD provider.

2.5. There are a number of different reasons for entering into a CfD contract. Our research includes a survey of a number of market participants, including investment banks and brokers, (the findings of which are set out in more detail in chapter 3 and Annex 4). It indicates that the main reasons for entering into a CfD relate to the scope to gain leverage, the ability to pursue long/short strategies and the scope to acquire an interest without being subject to stamp duty. Other reasons cited include the ability to stake build without disclosure, as well as facilitating trading positions that are otherwise difficult to achieve. For example, short CfDs can facilitate a number of strategies, including pairs trading, merger arbitrage and a variety of hedges to protect existing long positions. For instance, by entering into a short CfD on the FTSE index, an investor can protect his long position in a particular FTSE stock against general market movements.

Box 1: Reasons for trading in CfDs

Market participants tend to give the following reasons for entering into a CfD rather than buying (or selling) the underlying stock:

- Leverage: trading on margin enables an investor to enter into a position on a leveraged basis without having to fund the full purchase price. The investor is required to provide initial collateral at between 5%-10% of the nominal value when the contract is opened. So a small percentage change in the share price can result in a large percentage gain (or loss) on the deposit or margin required to open the CfD.
- Ability to go short: The ability to enter into CfDs geared to falling as well as rising prices allows investors to benefit from a fall in the price of an underlying stock (in exactly the same way as going short in the shares themselves but without needing to be responsible for purchasing shares for delivery).
- Stamp Duty: investors in UK equities are currently subject to stamp duty of 0.5% on every transaction. As CfDs are a derivative product there is no stamp duty payable (and where hedging is conducted by a recognised intermediary (persons recognised under Stamp Duty and Stamp Duty Reserve Tax intermediary and stock lending relief legislation), the hedging activity is also likely to be exempt from stamp duty).
- Greater market opportunities: CfDs allow investors to gain exposure, at relatively low cost, to a very wide range of stocks, market indices, currencies and other assets.
- Maintaining secrecy and anonymity: as few jurisdictions require disclosure of purely economic interests, some investors value CfDs as a means of taking substantial positions without public disclosure of their trading strategies.

Growth of the CfD market

2.6. Over the past five years the growth of the CfD market has been significant. Some commentators believe that between 20% and 40% of turnover in the cash equities market is now driven by activity in related derivative products. In bid situations, this is likely to be nearer the top end of the scale.

2.7. The most significant drivers behind this recent trend are investors wanting higher leverage when seeking exposure to equity price movements and demand for new ways to short stocks. In addition, the evolution of the internet and electronic trading platforms has reduced transaction costs involved in undertaking CfD transactions.

2.8. The financial markets make almost no disclosure of CfD trading activity, and as a result there is only limited availability of data which depicts the recent growth of the CfD sector. The charts below are based on a sample of data obtained from a group of major CfD providers in the UK and relate to their sterling denominated equity products only. They provide a broad indication of the considerable growth in CfD trading activity that has taken place since 2001.

2.9. Chart 1 captures the growth in the number of quarterly CfD transactions over the last six years and shows that the CfD market has grown at a particularly high rate since 2003. Although the trend depicted in Chart 2, relating to the total value of CfD transactions since 2001, includes a slight decline during 2006, this illustrates a significant growth in the CfD market as well. Chart 3 (based on London Stock Exchange data) shows the corresponding growth in the value of domestic equity transactions, and highlights the relative growth of CfDs from around 10% of equity value in 2001 to around 35% in 2007.

Chart 1

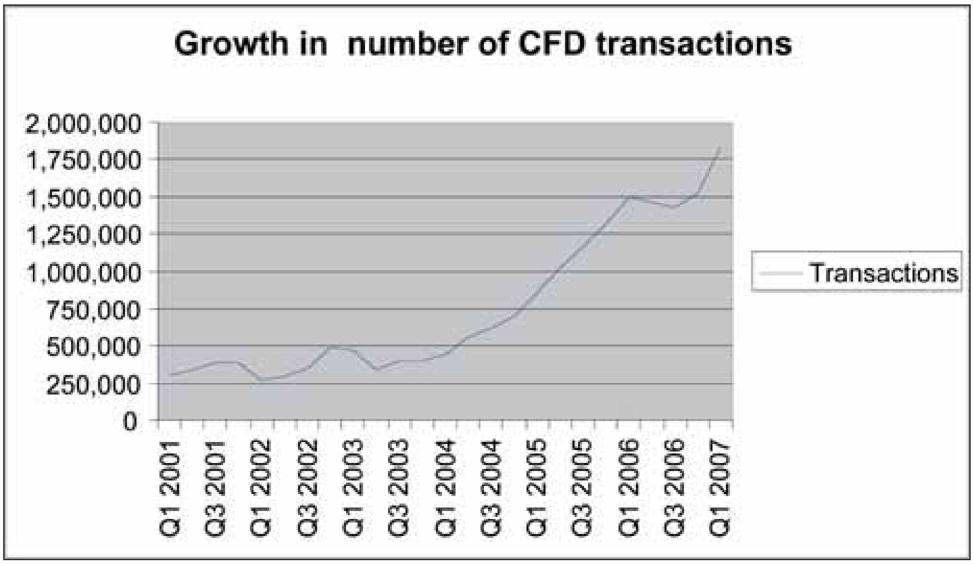


Chart 2

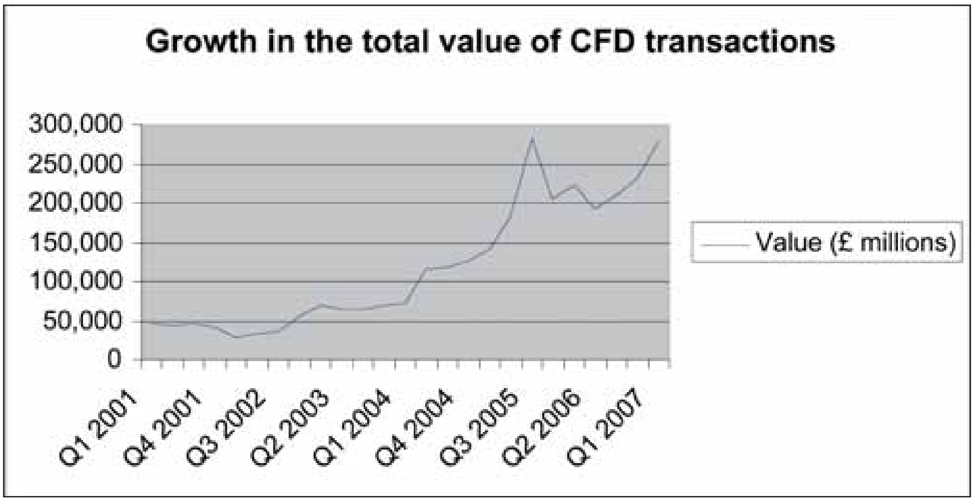
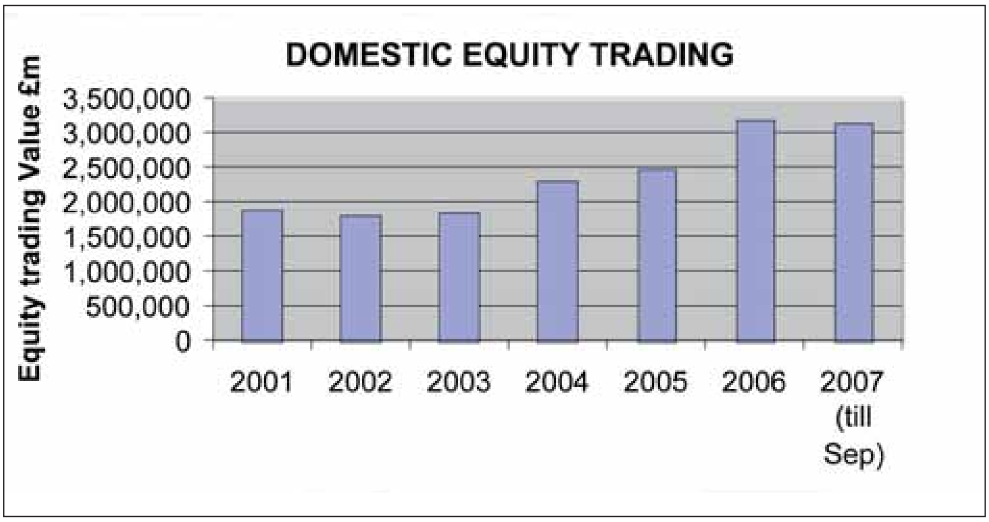


Chart 3



Regulatory Framework

2.10. The Disclosure and Transparency Rules (DTRs), which now govern the disclosure of major shareholdings, do not require the disclosure of economic interests in shares. However, holders of CfDs are not completely outside the scope of regulatory requirements. CfDs may be disclosable under the DTRs if CfD holders have formal or contractual rights to exercise voting rights, or acquire underlying shares. And since November 2005 the 'City Code on Takeovers and Mergers' (Takeover Code) has required the disclosure of economic interests in certain circumstances (see below, paragraphs 21-25) In this section we set out the UK's current notification and disclosure requirements for investors and companies respectively outside offer periods. We also note the obligations that flow from the Market Abuse Directive (MAD) and the Financial Services and Markets Act 2000 in relation to representations made about CfD positions. Finally, we describe the Takeover Panel's disclosure rules as they apply to dealings in CfDs.

Disclosure and Transparency Rules

2.11. The UK has had a notification and disclosure regime for major interests in shares for several decades. Until 2007 oversight of the UK's major shareholding regime lay with the Department of Trade and Industry (DTI) under Part VI of the Companies Act 1985. With the implementation of the Transparency Directive (TD) in January 2007 responsibility for overseeing major shareholding disclosures passed from the DTI to the FSA. We have implemented the requirements of the TD through the DTRs. It should be noted that FSMA section 89A(3)(b), together with 89F(1)(c), gives us powers to extend our rules to include instruments with a similar economic effect to financial instruments that give a legal entitlement to acquire shares.

Benefits of disclosure

2.12. The TD is one of the building blocks of the European Commission's Financial Services Action Plan (FSAP). The overall objective of the FSAP is to promote the competitiveness of the European economy. Sufficient transparency and disclosure are seen as key preconditions to liquid and efficient markets that, in turn, should lower the cost of capital for companies and deliver benefits for investors.

2.13. In particular, the purpose of transparency rules, as stated in the TD is that '*the disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency.*' The rules are aimed at disseminating relevant information to all interested shareholders as quickly as possible. In relation specifically to major shareholdings, '*the public should be informed of changes to major holdings in issuers whose shares are traded on a regulated market situated or operating within the Community. This information should enable investors to acquire or dispose of shares in full knowledge of changes in the voting structure*'.

2.14. Articles 9-12 of the TD therefore require significant shareholders of a company with securities traded on a regulated market to notify both the issuer and its Competent Authority when its holdings cross certain thresholds. For UK issuers we have retained the thresholds set by the Companies Act 1985 of 3% and every 1% after that, subject to certain exceptions, as the triggers for these notifications.

2.15. The Companies Act 1985 defined the disclosure obligation as extending to interests of 'any kind whatsoever in [the] shares'. Specifically, it brought within scope contracts and other arrangements, such as call options, warrants and other types of options that enabled a person to acquire or to exercise control over the rights conferred on a shareholder. Similarly, it included instances when a person was obliged to take delivery of shares, for example, as the result of writing a put option. However while the statutory definition of interest was wide, it was never interpreted to extend to arrangements whereby a person held an interest in a share that was purely economic (i.e. without the entitlement to exercise any right conferred by the holding of such a share). Thus a holder of a CfD who was not entitled to any rights in the underlying share was not required to disclose when they acquired or disposed of a contract (or contracts) in aggregate equivalent to 3% or more of a class of shares.

2.16. The DTRs, which follow the provisions and definitions in the TD, are therefore referenced to direct and indirect control of voting rights attaching to a share, as opposed to the concept of notifiable 'interests in shares' established under the Companies Act 1985. They also require (DTR 5.3.2R) disclosure of entitlements to acquire voting rights resulting from holding certain financial instruments, including transferable securities and options, futures, swaps, forward rate agreements and any other derivative contract referred to in Section C of Annex 1 of the Market in Financial Instruments Directive (MiFID). Accordingly, major positions in physically settled call options have to be disclosed to the market, while positions in CfDs generally fall outside the scope of the DTRs, unless the contracts explicitly give a right to acquire, or give access to the voting rights attached to, shares held as a hedge by the CfD writer.

2.17. The DTRs allow a number of other exemptions from disclosure. In practice, these are likely to make it more difficult to identify market activity in cash equities that come from the origination and termination of CfDs. There are two main exemptions. First, shares held by a market maker need not be disclosed until they reach a 10% threshold (5.1.3R(3)), on condition that the market maker does not intervene in the management of the issuer concerned. And second, shares held by a credit institution or investment firm within its trading book are exempt from disclosure until they reach a 5% threshold, provided that the firm ensures that the voting rights attached to those shares are not exercised (5.1.3R(4)). If market makers and investment firms do not meet these conditions, they are required to make notifications at the 3% threshold in the usual way.

Market Abuse Directive

2.18. The UK's implementation of the MAD came into effect on 1 July 2005. The Code of Market Conduct, which is part of our Handbook, sets out the types of behaviour which could constitute market abuse under the terms of the MAD. This includes (Market Abuse Rules 1.8.1) 'the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a [qualifying investment] by a person who knew or could be reasonably expected to have known that the information was false or misleading'.

2.19. Transactions entered into with the intention of circumventing the current disclosure obligations, e.g., with respect to stake building, could, in some circumstances, possibly fall foul of the rules designed to prevent market abuse.

Financial Services and Markets Act 2000

2.20. The Principles for Businesses set out in our Handbook apply to authorised persons. For example, we would regard any authorised firm misrepresenting its position as potentially failing to conduct its business with integrity and/or not observing proper standards of market conduct.

Takeover Panel rules

2.21. Although the DTRs apply the main shareholding disclosure regime, the UK Takeover Code makes some additional disclosure requirements during takeover bids. With effect from November 2005, the Takeover Panel adopted new dealing disclosure rules that extend dealing disclosure obligations to persons with economic interests in the shares of the offeror or offeree company.

2.22. In summary, the rules now require that if, during an offer period, a person directly or indirectly has an interest, including an economic interest, in 1% or more of any class of relevant securities of an offeror or of the offeree company, or as a result of any transaction will have an interest in 1% or more, then all dealings in any relevant securities of that company by that person (or any other person through whom the interest is derived) must be publicly disclosed.

2.23. Under the Panel's rules, a person will be treated as having an interest in securities if they:

- own or control them;
- have a call option or written put option in respect of them; or
- have a long derivative referenced to them.

2.24. Dealing includes any action which results in an increase or decrease in the number of securities in which a person is interested, or in respect of which he has a short position, including:

a) acquiring or disposing of securities;

b) taking, granting, acquiring, disposing of, entering into, closing out, terminating, exercising or varying an option in respect of securities;

c) subscribing or agreeing to subscribe for securities;

d) exercising or converting any securities carrying conversion or subscription rights;

e) acquiring, disposing of, entering into, closing out, exercising any rights under or varying a derivative referenced to securities; and

f) entering into, terminating or varying the terms of any agreement to purchase or sell securities.

2.25. When putting forward its proposed rule changes, the Panel noted that:

- persons with long derivative or option positions may, through the securities held by their counterparties, exercise a significant degree of control over the securities the derivative is referenced to or that are subject to the option;
- persons dealing in derivatives and options may be dealing with a view to helping one of the parties to the offer, with the result that they should be considered to be acting in concert with the party;
- the disclosure of dealings in derivatives and options would enable shareholders to understand better the forces at work in the market and, in particular, the reasons why the prices of offeror or offeree company securities may be moving in a particular direction; and

- in the context of a bid, a derivative investor or option holder with a purely economic, rather than strategic, motivation is still likely to want to influence the way in which the holder of underlying shares acts in respect of an offer for the company.

Companies Act 2006

2.26. Section 212 of Companies Act 1985 gave a public company the power to investigate the ownership of its shares. Companies did this by sending a written notice (the '212' notice) to any person or company whom they had reasonable cause to believe had, or had had, an 'interest' (for example by owning, controlling or holding certain rights over shares) in their relevant share capital at any time during the three years immediately preceding the date of issue of the '212' notice. This provision has been carried forward to the Companies Act 2006 and is now set out in section 793 of the Act.

2.27. Table 1 summarises these various regulatory and legislative provisions. It highlights that, in a number of important respects, some of the behaviours that are causing issuers and investors concern are already caught by our, and others', rules.

Table 1

Current Legislation	What the rules say	How they might apply
FSA Handbook – High Level Standards	*Applies to authorised firms*	
PRIN 2.1.1 R	1. A *firm* must conduct its business with integrity. 5. A *firm* must observe proper standards of market conduct.	Any firm misrepresenting its interest held through CfDs, or its access to voting rights, may be falling short of standards required by authorised firms.
Disclosure and Transparency Rules	*Applies to listed companies (for issuers) and persons holding voting rights for MSNs*	
DTR 5.1.2	A person must notify the issuer if his holding of voting rights attached to shares exceeds 3% or exceeds of falls below one of the thresholds.	A person who buys a large amount of shares has a requirement to make a notification.
DTR 5.1.3/5.1.4	Shares held by a market maker, up to a holding of 10% [5.1.3R(3)], are not required to be notified to an issuer as long as the market maker **does not intervene in the management of the issuer.**[5.1.4R(1)(b)]	A CfD holder instructs the CfD writer, who holds shares in the company as a hedge that are exempt from disclosure, to vote the underlying shares in a certain way. By exercising the votes on the instructions of the CfD holder the CfD writer would lose the disclosure exemption, and would have to disclose its interest in the underlying shares.
DTR 5.1.3 (4)	Shares held within the trading book of an investment firm or credit institution which do not exceed 5% of voting rights may be disregarded for notification purposes, provided that the voting rights…are not exercised or otherwise used to intervene in the management for the issuer. Again, any attempt to vote shares would negate the exemption and require a disclosure.	

Current Legislation	What the rules say	How they might apply
DTR 5.3.1	A holder must make a notification if it holds, directly or indirectly, certain financial instruments which result in an entitlement to acquire, on the holder's own initiative alone, issued shares to which voting rights are attached.	Where someone buys a call option over shares which would give access to a notifiable level of voting rights, they would have to make a disclosure. Likewise if a CfD holder had a right under the contract to buy the shares at closure of the CfD, it would also have to make a disclosure.
Market Abuse Rules	*Applies to all market participants*	
MAR 1.8.1 Market abuse (dissemination)	Market abuse [includes] 'the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading.'	Any firm misrepresenting its position publicly by claiming an interest through CfDs that they do not possess, which could have an effect on the market, could be in breach of the Market Abuse Rules.
Companies Act	*Applies to public companies and people with an interest in shares*	
s.793	A public company has the power to investigate the ownership of its shares by sending a written notice to any person or company whom they had reasonable cause to believe had, an 'interest' in its shares.	If a person who holds a CfD, through which they can acquire shares or exercise votes, receives a request from an issuer whether or not they hold an interest in shares, they must confirm or deny the fact, and, if the former, disclose certain information about the interest.
Takeover Code	*Applies to persons dealing in an offer period*	
8.3(a)	During an offer period, a person holding 1% or more of any class of relevant securities of an offeror or of the offeree company must disclose any transactions in shares or financial instruments (including CfDs) relating to those companies.	A person or firm has built up a significant economic interest in a company, by holding a large CfD position. The company is then involved in a takeover. If the person later deals during the offer period, either in shares or in derivatives, they will have to disclose all their interests including their CfD positions.

3 Potential Market Failures

3.1. In this chapter we first summarise the issues which have been raised in our discussions with a range of issuers, investors and other market participants. Some, but not all of these issues, suggest that there may be potential market failures associated with non-disclosure of CfD positions. The second part of this chapter summarises what these market failures may be.

Views of issuers and investors

3.2. Discussions, both academic and in the media, of the possible issues caused by the absence of CfD disclosure are often covered as part of wider analysis of what is sometimes termed 'new' forms of voting. We have taken into account a number of these discussions in our evaluation of the evidence. It is worth noting that in some of the instances given by market participants as examples of problems, the use of CfDs on an undisclosed basis is not the main underlying issue.

3.3. This said, we have taken into account a number of cases in the public domain where non-disclosure of CfDs is held to have undermined market efficiency or the positions of other investors, and others where the evidence remains more circumstantial. From these it is clear that CfDs have sometimes been used on an undisclosed basis as a platform for establishing significant equity stakes, or as a means of seeking to exercise influence over issuers' corporate governance.

3.4. Some share issuers argue that in the absence of disclosure of large CfD positions market transparency is impaired and effective communication between companies and their shareholders is significantly hampered. Their concerns can be grouped under three broad headings:

a) Asymmetry of information

- The market (that is, all investors) needs to know who a company's significant shareholders are, and CfD holders gain an advantage over 'traditional' long holders of shares by not having to disclose their significant holdings;

- For the duration of the CfD it is only the CfD holder and the CfD writer who know the holder's identity, intentions and the relevant time-horizon. This creates an information asymmetry that can lead to imperfect pricing in the market;
- This lack of transparency is increased by CfD writers hedging their positions with the underlying shares which may be held and registered in several different accounts, including their proprietary trading or their market-making account. Issuers and the market more generally may therefore be unable to determine whether large positions are being taken for hedging or proprietary trading purposes. This could cause speculation in the market, which could in turn lead to increased volatility and a consequent increase in the cost of capital for issuers;
- Block trades can cause further lack of transparency if the underlying shares are held as hedge against CfDs. For example, it is possible that a CfD writer might acquire the underlying shares for use as a hedge. This position would not be disclosed if the hedge stock was held in an account exempted under the DTRs. When the CfD contract is closed out, the shares could be sold in a block trade, without any transparency as to the identity of the seller. The market could then see a large sale, and wrongly assume it was a major long term shareholder on the share register disposing of shares. This could cause market speculation and possible damage to the valuation of the company.

b) Exercise of influence on management

3.5. Holders of CfDs can approach the management of an issuer company wanting to influence corporate decisions. In these situations, as there has been no disclosure of the CfD position, the company may not be able to verify the level of economic interest (if any) held through the CfD, or whether the CfD holder has any access to voting rights. The company therefore has to decide whether or not to enter into discussions with the CfD holder with no knowledge of the CfD holder's true position.

c) Undisclosed stake-building

3.6. Finally, CfDs can be used to build up large economic positions in a company prior to a possible takeover without any transparency to the company or to the market. If the CfD holder has an informal agreement to take delivery of the shares on closing out the contract, or even knows that they are in a strong position to acquire the hedge, the disclosure requirements set out in the DTRs are effectively circumvented, as there is no legal entitlement to acquire. In this case, a potential acquirer can target a firm by entering into a CfD contract with a bank. The bank will buy the target's equity as a hedge. The acquirer will then close the CfD position, buy the equity which the bank is holding, thereby surprising both the issuer and the market by suddenly owning a large stake in the company. This strategy takes advantage of the fact that the bank is likely to enjoy an exemption from disclosing the hedge shares until its interest in the shares reaches 10%. Also, the bank will have strong incentives to sell the equity to the CfD holder if the acquirer wants it because a large equity position may otherwise be difficult to unwind.

3.7. Institutional investors have expressed a broadly similar range of views, particularly regarding the exercise of influence over companies by CfD holders who claim to have access to voting rights and with regard to operating in a market where others may have better information.

Views of CfD writers/holders

3.8. In our discussions with writers and holders of CfDs (mainly hedge funds) the view was expressed that increased disclosure of CfD positions could make the market less efficient by:

- confusing the investor community and companies;
- creating complex situations of 'potential' shareholdings which could create a 'false' feeling of interest in the market, and
- increasing volatility in the market.

3.9. In addition, investment banks in general suggested that their internal policies would be not to accept voting instructions from a CfD holder on how to vote hedged stock. They also said they did not close out a cash-settled derivative with the underlying shares and would only subsequently sell the underlying shares to the CfD holder in very specific circumstances (and not directly before a significant corporate event).

3.10. Hedge funds all argued that if they wanted to exert control then they would buy physical stock and they did not expect banks to vote at their request. In addition, their motivations for buying CfDs were most often unrelated to stake building but driven by tax considerations, leverage and/or the scope offered for taking short positions.

3.11. Some hedge funds shared the view of the investment banks that increased disclosure would make the market less efficient (although some smaller funds (reflecting their size) felt that it would not be a specific issue for them). Several argued that what is seen as a lack of transparency is in effect a legitimate factor underlying hedge funds' trading strategies. In addition the concern was expressed that higher disclosure requirements would result in less liquidity in the market as firms would limit their holdings to avoid disclosure or the extra compliance burden, and more fundamentally that this would threaten their business models. But some shared the view of issuers that more information would result in better price formation.

Possible market failures

3.12. These discussions suggest there are two distinct sets of issues. The first relates to transparency when there is access, or potential access, to voting rights. The second relates to the wider question of whether there should be greater disclosure of economic interests generally. In both cases, the key question is whether the absence of transparency amounts to a market failure and, if it does, whether there is proportionate action that could produce an improvement to the market (i.e. where the benefits exceed the costs). In the rest of this section, we consider some of the adverse consequences of the lack of disclosure indicated by issuers and investors.

3.13. Out of the concerns raised by issuers and investors, we identify the following possible market failures. We then go on to test the extent to which they actually occur.

(a) Inefficient price formation

3.14. Information asymmetries between informed CfD holders and uninformed 'ordinary' investors can result in price inefficiency in the market. Uninformed investors may be unable to acquire valuable information because it is held with informed traders. Valuable information in the context of CfDs which could affect pricing of the referenced shares could include information on those holders of large CfD positions who are able either currently or prospectively to exercise ownership rights over the reference shares, as described below.

(i) Banks voting on behalf of the CfD holders. While other information can become incorporated into the market through the consequences of trading behaviour, if there is 'hidden' voting then this information asymmetry will not be addressed by the current Major Shareholder Notification (MSN) regime. If information on who holds voting rights is valuable but is not available to the market, prices will be inefficient as they will not reflect all the market information. For example, if the market had knowledge of a bank voting on behalf of an activist investor, prices may react to reflect that fact. Without public disclosure, prices may stray from efficient levels for longer periods of time. As we said in chapter 2, banks exercising voting rights lose the ability to benefit from the market maker and trading book exemptions.

(ii) Acquisition of the underlying equity hedge. Another problem can arise if the CfD holder acquires the underlying equity upon or shortly after closing of the contract and surprises the market with the sudden acquisition of a large stake. Strictly speaking, this case is no different from the case where a market participant is able to buy the cash equities directly. However, the possibility of making such an acquisition through CfDs is more plausible, as it may be difficult to build up a large directly-held stake if an initial 3% holding had been made public (it would be difficult to find a seller who would for example sell 5% of a company). However, in both cases (unless the acquirer benefits from a DTR disclosure exemption) the existing MSN regime will ultimately require disclosure (upon acquisition of the equity), which limits the extent of the information asymmetry. We do note, however, that there is a greater possibility of surprising the market with a large ownership interest built through CfDs which could in some circumstances create speculation, price volatility and adversely impact existing shareholders.

3.15. Both of these potential market failures in price formation relate to a lack of disclosure where a CfD holder can in practice, or is ultimately seeking to, influence voting rights. This leaves the question of whether non-disclosure of pure economic interests may contain information that might, if disclosed, influence the pricing of the reference share. That could be the case if either (i) it was clear that holders of large CfD positions could, by virtue of their economic position, exercise similar influence over an issuer's management as the holder of votes; or (ii) the disclosure of a large position by a particular market participant was used by the market to price the shares.

3.16. We do not have clear evidence whether CfDs held as pure *economic interests* – i.e. with no intention to link to the voting rights - can create problems of inefficient price formation. We expect equity market prices to reflect information on market trades, including those in both the underlying equity and perhaps in the CfDs themselves. Where CfD writers hedge the contract, and buy the underlying equity at the time of a CfD sale, the market will price in the acquisition of those shares. Arbitrage opportunities should exist for only a short period of time and prices will converge to a new equilibrium that reflects all information, including information from the CfD market. Jayaraman, Frye and Sabherwal (2001) give evidence of this mechanism in the options market.[2] This suggests that information on the identity of the CfD holder, which will not be available to the market, can be important if CfDs are being used for insider trading. However, market abuse is already addressed through the relevant provisions of FSMA (Table 1 above). In other cases, the study suggests the identity of the owner is not significantly important to price formation, unless the owner has access to voting rights. So, with the exception of insider trading, the pure economic interest of CfDs does not appear to create a significant problem of inefficient price formation.

3.17. Some have also argued that uncertainty, on whether substantial sales of equity are related to stocks hedged against CfD contracts, creates information asymmetries, resulting in price volatility. This problem would again relate to the operation of CfDs, irrespective of the voting rights issue. For example, a CfD involving a material number of shares may be closed by a CfD holder, and the CfD writer may, at the same time, sell the underlying stock that was originally bought to hedge the CfD. This type of transaction has the potential to result in a significant block trade, which the market may have difficulty in interpreting. That is, the market will see the block trade (in terms of the price and volume of the transaction in the market[3], and also through a possible disclosure through the MSN regime), but the true reason for the sale will not be available to the market (i.e. that it was for hedging). It is argued that this information asymmetry can create speculation in the market about the intentions behind the sale.

3.18. However, lack of full information on intentions or reasons for purchase and sales is a fundamental element of markets. Lack of full information itself is not a market failure[4]. In no 'real world' markets do all participants have full information. All markets are imperfect to some degree. In order for us to apply the term 'market failure' the imperfections need to be large enough to suggest that regulatory intervention has a realistic prospect of improving market outcomes. Even in the case of MSN disclosures, the intention behind purchases or sales of large blocks is undisclosed, which can generate market speculation. Moreover, our analysis (see Annex 3) shows that on average there are no significant price movements when banks announce substantial sales of equity. Therefore, even if there is speculation (and volatility), it does not appear to create a systematic failure in the market that can be corrected through the use of regulation.

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2 Jayaraman, N, Frye, M B and Sabherwal S (2001) *Informed Trading Around Merger Announcements: An Empirical Test Using Transaction Volume and Open Interest in Options Market, Financial Review* (May 2001)

3 Under MiFID, there is post-trade transparency for all transactions in shares admitted to trading on a Regulated Market.

4 Indeed it had been demonstrated that markets with perfect information are an impossibility (see Grossman SJ and Stiglitz JE, 1980). Perfect information is not a feature of any real world markets and indeed full disclosure mandated by regulators is probably undesirable (see Greenspan 2002).

(b) Distorted market for corporate control.

3.19. It is argued that CfDs can also be used as a tool to build stakes in quoted companies before a takeover period, avoiding the need to make MSN disclosures that are necessary when shares are purchased. The lack of notification allows stake-builders to gain enough of a 'toehold' in the firm which can be converted into direct equity interest when they acquire the physical from the CfD writer who is holding these shares as a hedge. 'Toeholds' could discourage other potential bidders from contesting the takeover, as they are at a competitive disadvantage relative to a bidder who already has a toehold. Therefore, toeholds, especially in the form of stealth stakes, may discourage competitive bidding and can reduce corporate contestability. Overall, these uncertainties may reduce the efficiency of the market for corporate control, and dissuade some parties from participation in the market.

(c) Diminished market confidence / investor protection.

3.20. A lack of disclosure can worsen the information asymmetry between large shareholders and minority shareholders. This means that minority shareholders may remain uninformed and unable to react to changes in ownership of the company. For instance they may wish to sell stakes in a firm if there is large stake-building by insiders, but without this knowledge will be unable to act. Alternatively, if CfD writers are willing to vote on behalf of CfD holders, CfDs can allow in essence a form of hidden voting. In this situation CfD holders could direct banks to vote differently from the way the banks may have voted themselves. Without disclosure, investors may be deterred from participating in the market if they feel uncertain about who the players are.

(d) Information asymmetry for equity issuers

3.21. There is also a possibility of informational imbalance whereby equity issuers do not have information on the true owners of the company. This again relates to hidden ownership and hidden voting, which means the true owners may not appear on the shareholder register. This information asymmetry may result in an inefficient use of issuer's resources whereby they have to spend resources to determine the ownership claims of CfD holders. This lack of information may result in a welfare loss to issuers.

3.22. While this information problem is not primarily related to our objectives, there are some areas of overlap. In general, issues relating to the disclosure to companies of the identity of their owners fall within the remit of company law. In contrast, providing ownership information to the market falls primarily within the remit of the MSN regime (driven now ultimately by the Transparency Directive). There is of course overlap between these two remits. Ownership information is recorded on the shareholder registers, which are publicly available, and MSNs are disseminated to the market via the issuers. We are responsible for the MSN regime rather the company law regime. To this extent, the consequences for issuers in terms of their ability to contact their true owners is not primarily a direct issue for us, although we recognise that the MSN regime indirectly supports the Companies Act provisions that relate to the shareholder register.

Conclusion

3.23. There are several concerns which issuers and investors have raised about the consequences of non-disclosure of CfD positions. Consistent with our approach to regulatory interventions, we have assessed whether these consequences result in any market failures. We think that there are three possible market failures, in relation to:

– inefficient price formation;

– a distorted market for corporate control; and

– diminished market confidence.

3.24. The next chapter summarises the analysis that we have carried out to establish the degree to which these three possible market failures are occurring in practice.

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

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?

4 Market Failure Analysis – The Evidence

4.1. In this chapter we set out the analytical work that we have carried out to find out the extent to which the market failures described in the previous chapter arise in practice. We have aimed to conduct our research in a systematic and rigorous way so we can base our discussion on empirical data as well as taking into account anecdotal information.

4.2. We have carried out four main projects:

(a) A review of the literature that explores the impact of information and disclosure on the price efficiency of securities markets, the market for corporate control and investor protection and corporate governance. This has sought to answer the following questions:

- in theory, does disclosure of information about major shareholdings improve price formation?
- what are the costs of disclosure (can it be, for example, misleading or confusing)?
- does disclosure improve the market for corporate control and thus strengthen the push for good corporate governance which will in turn benefit minority shareholders?
- does disclosure in itself improve corporate governance and thus enhance investor protection?
- to what extent might the answers to these questions apply to the disclosure of CfD positions? In particular, to the extent that disclosure of actual shareholdings is beneficial for price formation, corporate control, and governance, how far would this also hold true for disclosure of CfDs?

(b) An empirical study of the impact of Major Shareholder Notifications (MSNs) on price formation. This has sought to answer the following questions:

- in practice, is information contained in MSNs valuable to the market in terms of price formation?
- do particular types of announcement have more value than others?

- how might the answers to these questions apply to disclosure of CfDs? In particular, if MSNs are valuable, in what circumstances would this support the case for CfD disclosure?

(c) An extensive study, carried out for us by PwC, of the practices of several of the most active CfD writers and other market participants. This has sought to provide the following information:

- the motivation behind CfD trading;
- policies and practices in relation to hedging, settlement and the exercise of voting rights, and the extent to which these may allow potential use of CfDs to substitute in some ways for ownership of the underlying shares; and
- views on the costs/benefits of extending the current disclosure regime.

(d) A study of the level and pattern of CfD trading inside and outside of offer periods for selected stocks. This has sought to answer the following questions:

- Is CfD activity during the offer period for the stocks in question similar to the level of activity before the offer period?
- Has there been any impact on CfD activity following the extension of the Takeover Panel regime?

4.3. The key findings of each of these studies are summarised below and the studies themselves can be found in the Annexes to this paper.

4.4. We have also analysed examples of trading situations where CfDs may have been a significant factor, and we have looked at the approach of other jurisdictions to CfD disclosure.

Literature Review

4.5. As described in chapter 2, an objective of the Transparency Directive is to give investors more information on major shareholders, or on those who have the ability to exercise material influence over an issuer. Although very little economic literature directly addresses the issue of disclosure of major shareholdings, there is a large body of literature that examines the possible impact of information and disclosure on (a) price efficiency of securities markets, (b) the market for corporate control and (c) investor protection and corporate governance. We have examined this literature and its possible implications for disclosure of CfDs.

4.6. The principal findings of this review are set out in Box 2 below, with more detail in Annex 2.

Box 2. Summary of findings of literature review on disclosure

In theory, does disclosure of information about actual major shareholdings improve price formation?

- Transparency in general is important for improving price discovery and formation, but this link depends on how information is distributed amongst participants.
- Mandatory disclosure ensures that private information is disclosed effectively and quickly into the market and is particularly important where traders have diverse information.
- By revealing new information, major shareholding disclosure should remove information asymmetries and result in lower variance in prices and higher volumes.
- However, requiring too much information may reduce liquidity, for example because traders restrict their holdings to below disclosure thresholds to avoid disclosure.

Does disclosure improve the market for corporate control and thus strengthen the push for good corporate governance?

- Disclosure of large acquisitions made as a prelude to a takeover (a 'toehold') can serve as an important means for the market of identifying potential takeover targets.
- But by driving up the price of subsequent acquisitions of shares disclosure can reduce the anticipated profit for the stake-builder and therefore could reduce takeover activity.
- Against this, toeholds can discourage other potential bidders from contesting a takeover because a bidder with an existing toehold will have more incentive to remain in the bidding.
- So disclosing toeholds could improve the market for corporate control.

Does disclosure in itself improve corporate governance and thus enhance investor protection?

- Poor disclosure can worsen the information asymmetry between large and minority shareholders. Minority shareholders will remain uninformed and unable to act on information on ownership of the company.
- Voting rights have value because they provide the holder of significant votes with influence in key decisions of the firm. Thus, knowledge on them is important.
- Lack of disclosure of the identity of major shareholders increases the risk of these shareholders trading on inside information and extracting benefits at the expense of minority shareholders.
- Knowledge of vote-buying by insiders (e.g. family owners) can provide indicators to outside shareholders or the market generally of further entrenchment.

- The value of control can be estimated and so disclosing major shareholdings can be informative to the market and particularly minority shareholders.

To what extent do the answers to these questions apply to the disclosure of CfDs?

- There may be a case for disclosure of information on major CfD positions as an extension of information on major holdings of voting rights in improving price formation. However, this is likely to be relevant only to the extent that CfD positions are closed out with the underlying stock and/or CfD writers, who have hedged with the underlying stock, vote on behalf of the CfD holders. If CfDs are rarely closed out with the underlying stock, and/or there is little voting on behalf of CfD holders, the benefits of mandatory disclosure would be limited.
- In relation to investor protection, CfDs could be used as a means of exercising undisclosed votes. Investors might not be aware of who else was exercising control of their company. However, CfDs would allow voting of undisclosed holdings only to the extent that CfD writers who have hedged with the underlying stock are willing to vote on behalf of the CfD holders.
- There may be a stronger case for disclosure in relation to the market for corporate control. By providing information on stake-builders who may use CfDs as a prelude to acquiring the underlying stock, disclosure could help to make takeovers more competitive and thus benefit shareholders.
- Overall economic arguments would suggest that, for CfD disclosure to be valuable, it needs to be strongly linked with having access to the voting rights.

Impact of Major Shareholder Notifications (MSNs) on price formation

4.7. As a step towards understanding the value of ownership disclosures in practice, we evaluated the information content of MSNs using a sample of MSN announcements made between January 2006 and August 2006. If the market values MSN disclosures, then any such announcements should result in significant abnormal price effects around the time of disclosure. However, if these disclosures do not convey any important information to the market, then there should not be any significant price movements at this time. Most of the price movements should instead be captured around the transaction date.

4.8. To test the hypothesis, we collected data on all announcements related to MSN disclosures (i.e. holdings in company). Our initial sample included 2773 announcements for the eight months between 1 January 2006 and 30 August 2006. We employed a number of filters in arriving at our final sample (for example, if multiple announcements were made by a shareholder in an issuer on the same day, we took only the last announcement into consideration). We also separated out the data that did not include information on whether the announcement was the result of a sale or purchase. Out of the remaining 829 announcements, 473 included the date when the transaction actually took place. This information allowed us to evaluate the length of time between the transaction and announcement dates.

4.9. Using standard event study methodology we measured abnormal price effects both on the trading date and the disclosure date for purchases and sales to evaluate whether these abnormalities were statistically significant. Finding statistically significant price effects on either or both of these dates would provide evidence that trade information and/or MSN disclosures are of value to the market

4.10. The principal findings of this study are set out in Box 3 below, with more detailed results in Annex 3.

Box 3: Major Shareholder Notification study

Scope

- In order to better understand the information content of Major Shareholdings Notifications (MSNs) the study examined the impact on share prices of a sample of MSN announcements in the period January 2006-August 2006, looking at separate event windows both before and after the trade, and before and after the announcement.
- The detailed study sought to measure the price movements around the time of disclosure, and measure their statistical significance compared to price movements around the transaction time. Incidence of significant price movement around the disclosure would provide evidence that the disclosure contained information valuable to the market.
- The initial sample contained over 2,700 notifications, which included data such as transaction date, information on shareholder type, size of transaction and total shareholding after the transaction.

Findings

Is information contained in MSNs valuable to the market in terms of price formation?

- The results suggest that MSNs are of some value to the market and contain information that investors use in pricing issuers' shares.
- The study's results demonstrate significant price movements around the public disclosure date, in addition to any movement around the transaction date. The direction of price movements is in line with theoretical expectations. Large purchases that result in significant shareholdings indicate positive price movements and similarly large sales result in negative price movements.
- This conclusion holds after taking into account possible impacts on prices as a result of specific types of trade (e.g. block trades), or trades by specific market participants (e.g. hedge funds or private equity).

- In some cases the marginal value of disclosure was found to be lower where there was a large interval between the transaction and disclosure dates. This suggests that there is information in the transaction itself which it takes the market a little time to absorb, and that the longer the gap to the disclosure of the major shareholder notification, the less additional information such a disclosure will contain.

Do particular types of announcement have more value than others?

- Particular types of announcement appear to have more value, for example block trades or announcements related to particular types of shareholders (although it is to be noted that sample sizes for these specific types of announcement are quite small, and therefore the results need to be treated with caution).
- Some types of announcement showed price movements of up to +1.76% around purchase announcements and -2.20% around sale announcement.

How do the answers to these questions apply to disclosure of CfDs?

- The results generally demonstrate the value of MSN disclosures. It is difficult to link them directly to the case for CfD disclosures, but if the market makes a causal link between CfD holdings and ownership, there could be a case for expecting CfD disclosures also to have value to the market.
- Whether CfD disclosure would convey similarly valuable information to the market as MSN disclosures might depend on whether CfD holders also indirectly have access to voting rights (i.e. whether there is an actual link to the voting rights in underlying shares, or an ability to acquire those shares, and therefore the votes, or the market has a perception that such a link is likely).

Survey of market participants

4.11. The conclusions of both our literature review and our study of the impact of MSN disclosures suggest that disclosure may also bring benefits in the case of CfDs, but only to the extent where:

- CfD positions 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.

4.12. To establish more accurately the extent to which these conditions exist, we engaged PricewaterhouseCoopers to carry out a survey of the leading players in the derivatives market as to the market practices relating to CfD trading. The survey, which targeted thirteen firms (eight investment banks and five other market participants) most active in CfD training, was structured in two parts: an initial paper-based survey, followed by a more in-depth interview.

4.13. The scope of the survey was to explore:

- how CfDs work in practice;
- the motivation behind CfD trading and its potential role in influencing voting rights, stake building and impact on price formation, and
- what the participants thought of the adequacy of the current regimes for market transparency and of the case for introducing a disclosure regime for economic interests.

4.14. The key findings are set out in Box 4 below, with more detailed results in Annex 4.

Box 4: Survey of Market Participants

Client base and their reasons for trading

- Holders of CfD contracts were typically hedge funds, other financial institutions and other investment banks.
- Leverage, avoiding stamp duty and the ability to pursue long/short trading strategies, were given as the main reasons why clients entered into CfD trades rather than buying the underlying stock.
- All participants but one had documented policies covering controls and procedures on CfD trading, including the approach to the exercise of voting rights.
- CfD trading volumes generally increased around corporate events including profits announcements and takeovers.

Hedging practices

- All participants hedged their CfD exposures but using different methods. Some banks used more than one method depending on circumstances. Nearly all banks hedged some of the time with the underlying asset and about half sometimes used offsetting derivative positions.

Practices in relation to settlement of CfD contracts

- All participants said that their standard CfD sale documents did not provide for settlement of the contract in the underlying stock; some said that there had been instances where terms had been amended to include such provisions and/or where side agreements had been entered into containing an option to acquire the underlying hedge.
- Over half said that CfD positions were never closed out with physical delivery of the underlying stock, and the remainder said that this happened 1-20% of the time (although our understanding is that the true figure is at the lower end of this range).
- All participants except one said they would not enter into pre-arrangements in relation to selling the underlying assets to the CfD holder.

Policy on the exercise of voting rights

- All participants said that they did not accept client instructions on how to vote hedged stock even if the sale documents did not specifically exclude this possibility.
- 15% said that there had been instances where the sale documents had been amended to include agreements on exercising the voting rights in accordance with the client's instructions. This would make the holding disclosable under the DTRs.
- Most CfD writers said that they did not exercise the voting rights attaching to hedged stock unless it was in their economic interest to do so.
- Two-thirds said that clients sometimes tried to exert influence over voting rights attached to stock held as hedge.

Extension of disclosure

- A third of participants said that increased disclosure of economic interests would be beneficial to the market, to clarify whether positions were being held as hedge, to enhance market transparency or to show who held an economic or a voting interest.
- Two-thirds did not support increased disclosure, citing as reasons confusion, costs, multiple counting and the sufficiency of the measures recently introduced by the Takeover Panel.

CfD activity before and within offer periods

4.15. The survey of market participants suggests that there is some evidence that holders of CfDs use them, or seek to use them, in ways that may give rise to some of the concerns expressed by issuers. But the responses also suggest that these practices are not widespread.

4.16. We have also conducted some transaction analysis to see if there were clear signs of covert stake building through the use of CfDs in the lead-up to a takeover announcement and specifically to establish whether significant CfD activity could be identified outside the scope of the Takeover Panel regime. If so, this would support at least the consideration of further regulatory measures to address possible market failures.

4.17. To do this we carried out a study of CfD trading volume levels where the CfD was referenced to an underlying share of an issuer subject to a takeover bid. This study, using data from the FSA's transaction reporting system, considered monthly CfD activity in a sample of firms that were subject to takeover bids in 2005 and 2006. To consider the potential effects of the Panel's regime, we evaluated CfD activity referenced to shares in companies involved in takeover bids in three distinct periods: a period well before the Panel regime was extended (January-March 2005), a period just before (May-August 2005) and a period after the extension of the Panel regime (July-September 2006). The first 50 takeover bids in each of these periods were examined. The reported results, however, combine all 2005 data as we did not identify a difference between the two periods. We also identified that not all companies involved in a takeover bid had a CfD product written on them. For instance in 2006, of the 50 firms considered 39 had CfD activity.

4.18. The key findings of this study are set out in Box 5 below, with more detailed results in Annex 4.

Box 5: CfD Trading Activity

Is CfD activity during the offer period for the stocks surveyed similar to the level of activity before the offer period?

- There is no evidence of any systematic increase in the number of CfD contracts extant as the offer period gets closer (i.e. in the 'run up' to takeover bids).
- There is little difference between the number of CfD contracts extant before the offer period compared to the one month after the offer period starts.
- However, there is a significant change in the value of the contracts, which more than doubles in the month after the offer compared to the month before the offer.
- The figures indicate substantial usage of CfDs during offer periods, even following the Panel's broadening of its disclosure requirements.
- To analyse whether CfDs might be used for (covert) stake-building prior to the launch of a formal takeover, we looked at the top 5% of takeovers in our sample in terms of the value of the CfDs traded. This does not reveal any systematic build-up in the use of CfDs in the run-up to offer periods, and in turn does not suggest the significant use of CfDs as a means of stake-building before the offer period.

Has there been any impact on CfD activity following the introduction of the Takeover Panel regime?

- Our analysis also shows that, compared to 2005, there was little change in the value of CfD contracts in 2006, suggesting that the introduction of the Takeover Panel's enhanced disclosure regime in November 2005 has had little effect on CfD trading activity.

Review of Takeover Panel's disclosure rules

4.19. The disclosure rules of the Takeover Panel ('the Panel') as they were extended in 2005 are described in chapter 2. The key change was to amend Rule 8.3 to provide that long derivative and option interests count in the same way as shareholdings towards the 1% trigger threshold for the disclosure of dealings.

4.20. In 2007 the Panel undertook a review of the new rules and concluded that they had achieved their main objectives without imposing undue burdens on market participants and, accordingly, that they were a proportionate regulatory response to the increasing use of derivatives during bids.

4.21. The following points arising from the Panel's review should be noted:

- the new disclosure rules increased the number of Rule 8.3 disclosures by around 19.3% over the disclosures already required by the existing regime;
- the overwhelming majority of disclosures under the new regime involve dealings or positions in single stock CfDs;
- the Code Committee had no evidence to suggest that there had been a decline in market liquidity in bid stocks since November 2005; and
- 90% of the respondents said they were in favour of the new disclosure regime.

4.22. In addition the Panel said that it would consider three further issues raised by respondents:

- whether securities borrowing and lending transactions should be treated as dealings and, accordingly, should be disclosable;
- whether Rule 8.3 dealing disclosure requirements should be extended to persons with significant short positions; and
- whether there should be disclosure at the start of an offer period by those with an interest in shares over 1%, rather than waiting for disclosure triggered by dealing within the offer period.

Regulatory approach in other jurisdictions

4.23. As noted above, some concern has been expressed by CfD writers and holders that increased disclosure requirements could damage market liquidity and also harm the UK's competitive position. To assess the potential impact of CfD disclosure we have looked at the experience of other regulators, including those who have recently introduced new disclosure requirements, to assess the risk that more disclosure requirements could affect the competitive position of the UK markets. In all the jurisdictions which have introduced derivative disclosure rules, the requirements are part of overall disclosure regimes rather than having effect solely in takeover situations.

The European Union

4.24. We contacted a number of **EU Member States** to establish their current disclosure requirements. All said that they are closely following the Transparency Directive (TD). Accordingly, they require disclosure of holdings in 'financial instruments that result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, shares to which voting rights are attached' (Art. 13 para. 1 TD). None said that they were planning to widen this rule in order to demand disclosure of cash settled derivatives. It should be noted that the Committee of European Securities Regulators (CESR) recently issued a Call for Evidence on the Transparency Directive, which included as a possible issue for discussion the disclosure of derivative products. The response period closed in September, and CESR is now prioritising topics for discussion based on the replies.

Non-EU jurisdictions

4.25. For the most part, jurisdictions outside the EU do not provide exemptions similar to those in the TD in relation to market-making and trading book holdings. So, more major shareholdings tend to be disclosed to the market than is the case in the EU.

4.26. **Hong Kong** has probably the most far-reaching regime for the disclosure of major shareholdings. This was initially introduced in 1988. Since then a number of more stringent measures designed to increase market transparency have been implemented. These include:

- reducing the initial substantial shareholding disclosure threshold from 10% to 5%;
- shortening the disclosure period from five to three days; and
- requiring disclosure of changes in the nature of an interest even if the level of shareholding remains unchanged (e.g. on exercise of an option).

4.27. In 2001 the regime was further extended to require disclosure of all types of equity derivatives (as opposed solely to physically settled derivatives which was the scope of the earlier regime).

4.28. The current regime therefore captures a wide variety of derivatives, provided that the investor has the right to acquire or sell the shares or a right to a payment if there is a change in the share price. This means financial instruments such as options, warrants, convertible bonds, ADRs and stock futures are all covered. A person holding, writing or issuing derivatives is taken to be interested in the underlying shares and these interests, calculated on a gross basis (i.e. there is no netting between long and short positions), must be aggregated with physical holdings to determine a disclosure obligation.

4.29. The Securities and Futures Commission in Hong Kong has not carried out any statistical analysis of the effect of these rules on the market. However, it does not appear that either the equity or derivative markets have experienced any significant negative impact, as both have continued to expand in recent years. Banks writing CfDs have raised a number of concerns in relation to the process for disclosures rather than the principle itself (although the requirements may have encouraged market participants to develop instruments that do not have to be disclosed).

4.30. **Switzerland** introduced a new regime for the disclosure of major holdings in cash settled derivatives on 1 July 2007 and has recently consulted on a further expansion of its regime with effect from 1 December 2007. The previous regime required disclosure of major holdings in certain derivatives if the agreement provided or allowed for physical settlement. This provision was reviewed in the light of a number of corporate takeovers using cash-settled call options. The following points should be noted:

- The regime applies both inside and outside of offer periods and requires aggregation by connected persons.
- The new regime (since 1 July 2007) requires disclosure of a purchase or sale of rights convertible into shares or rights to acquire shares (particularly call options) and the writing of rights to sell shares (particularly put options), irrespective of the way of settlement. Additionally, holdings in the underlying stock have to be added to holdings in derivatives when establishing whether thresholds have been crossed.
- Reactions to the new regime have been mixed. Some market participants expressed the concern that the new requirements would decrease rather than increase the value of information available in the market. Others said that the new rules would go further than the TD requirements within the EU and, accordingly, be detrimental to the Swiss finance sector. Issuers, however, welcomed the changes.
- Switzerland is planning to introduce further changes, expected to come into force in December 2007. The new rules require disclosure of all instruments that have been entered into with a view to a takeover. A detailed description of which financial instruments fall under this rule, as well as the suggested changes regarding stock lending, have been delayed until 2008.

4.31. **Australia** requires disclosure of substantial holdings in shares or interests in a listed company. 'Relevant interest' is defined in section 608 of the Corporations Act 2001 and includes the power to exercise, or control the exercise of, a right to vote attached to the securities. It is understood that purely cash settled derivatives generally do not fall within the definition of 'relevant interest', while the disclosure obligation in such a case would lie with the investment bank holding the hedge.

4.32. The Australian Takeover Panel recently outlined its plans to prohibit the use of equity derivatives to mask the ownership of takeover targets, in response to several high-profile cases. The Panel said it had developed the draft guidance over two years following numerous instances where controlling interests had used equity derivatives to hide 'substantial holdings'. The central proposition is that for control and substantial holding disclosure purposes long equity derivatives (cash settled or deliverable) should be treated in the same way as physical holdings of the relevant securities. These proposals would apply to all derivative holdings, not just in takeover situations.

4.33. **New Zealand** requires disclosure of 'relevant interests' in 5% or more of the voting securities of a public issuer. According to article 5 of the Securities and Markets Act, a person has a 'relevant interest', amongst other criteria, if that person: (i) has the power to exercise (or control) any right to vote attached to the security; (ii) has the power to acquire or dispose the security, or (iii) has the power (or may at any time have the power) under an arrangement, to exercise any right to vote attached to the security, to acquire or dispose of the security. The courts have taken a broad approach to what represents a possible future power to acquire shares.

4.34. **The United States** large shareholder disclosure regime sets as a basic requirement disclosure at the time of acquisition of beneficial interests above 5% held directly or indirectly. Voting rights can be held through any contract, arrangement, understanding or relationship. Beyond this basic requirement there are a number of different treatments for specific types of firms:

a) some institutional investors who hold stock in their ordinary course of business and without the intent to influence control, are allowed to make an end-year report instead of at the time of acquisition;

b) institutional money managers (this would include hedge funds) must disclose holdings (over $100 million) at the end of each quarter, and

c) officers, directors and 10% shareholders (based on beneficial ownership) must disclose a broad range of other economic positions held, including options, warrants, equity swaps and other equity derivatives, whether cash or physically settled.

4.35. This brief survey of other regulatory approaches indicates that there is some move towards greater disclosure of derivatives positions in some jurisdictions outside the EU, largely driven by concerns over takeover situations or the exercise of voting rights more generally. Some of these moves are too recent for it to be possible to draw any conclusions as to their consequences. The experience of those regulators which have had disclosure regimes for some time does not suggest that disclosure of CfDs has had a negative effect on market growth or liquidity. In addition the widespread move towards general disclosure would seem to suggest that there is no reason to believe that additional disclosure requirements would significantly harm the UK's competitive position.

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?

5 Overall conclusions and policy options

Introduction

5.1. In this chapter we set out the overall conclusions that we draw from the analytical work described and summarised in the previous chapters. We also give some options for addressing the issues identified.

5.2. Our overall objectives in the work that we have carried out over the last year have been to use firm evidence to assess the extent to which the non-disclosure of CfDs causes market failures, and to consider whether and how those failures can be addressed in practice.

5.3. We have tried to make this assessment in as rigorous and open-minded a way as possible. As we said last October, in relation to the responses received to CP06/4, 'there was little consensus on the extent or significance of [these] market failures or to the potential costs and benefits of a disclosure regime. We have been provided with anecdotal evidence in support of stakeholder views but it has been more difficult to identify clear-cut empirical evidence which support the arguments cited.'

5.4. So we have considered the issues from several different perspectives. We have gone back to the theoretical principles that underpin market disclosure to understand what the potential benefits and costs might be of CfD disclosure. We have gathered some of our own empirical evidence to test the validity of these theoretical principles in practice. As part of this, and to ensure we understand the underlying concerns and objectives of all stakeholders, we have sought the views of a wide range of market participants, including issuers and investors, investment banks and hedge funds as well as those responsible for the Takeover Panel and Companies Act regimes. We have also taken particular note of recent market developments and a number of situations that have been reported publicly where the use of CfDs has been, or appears to have been, of particular significance.

5.5. We have summarised this work in this paper, and have included our own analytical work and other evidence as Annexes to this paper.

5.6. Last year we set out in PS 06/11 the three broad options that we saw as open to us in addressing any market failures that were identified. These were to maintain the current regime unchanged, strengthen the regime, or introduce a general disclosure regime.

5.7. These remain the broad options for consideration and it is against these that we have been assessing the evidence from the analysis carried out and discussions since last October. As they involve new rules, we need to be able to justify our proposals with evidence of the market failures caused by the current position, and clear and rigorous cost-benefit analysis. This analysis needs to consider not just direct costs on all market participants but also indirect costs. The potential costs of extended disclosure are in particular difficult to quantify. Again, we are setting this analysis out as fully as we can, together with the underlying assumptions. We fully recognise that the underlying assumptions are broad, so the outturns in terms of total costs could vary significantly. We would welcome alternative quantitative analysis on the costs and benefits of an extended disclosure regime.

Analytical framework

5.8. Given the complexity of the issues that have been considered, it is helpful to briefly repeat the overall framework that we have followed in assessing the evidence.

5.9. In chapter 3 we set out the possible market failures that could arise from the non-disclosure of CfDs (inefficient price formation, distorted market for corporate control, and diminished market confidence).

5.10. In order to propose new rules we need to be able to demonstrate that some or all of these market failures occur on a sufficient scale and in ways that are not caught by the current disclosure requirements.

5.11. As we noted in chapter 3, these failures could arise for two reasons. First, they may arise because of the economic interest that is inherent in CfDs that are not disclosed. This could lead to inefficient price formation. Second, these failures could be caused by the possible link that could be made between the economic interest of the CfD (again, when not disclosed) and the voting rights that are attached to the underlying shares. In the context of the broad policy options that we have open to us, we would as a starting point consider a general disclosure regime to be justifiable in cost-benefit terms either if there was clear evidence that not disclosing economic interest led to inefficient price formation, or if, even in the absence of market failures caused by the non-disclosure of economic interest, such a regime would be a proportionate and effective response to any market failures caused by the link between undisclosed economic interest and access to voting rights.

5.12. Also, after identifying the reasons why and the extent to which any of these market failures do occur, we also need to take into account the effectiveness of the existing disclosure and regulatory regime as a whole. Assessing the extent and effectiveness of the existing regime as a whole is integral to deciding what would be a proportionate response to any market failure.

What does the evidence tell us?

5.13. Taking the disclosure of pure economic interest first, we see only limited evidence of market failure arising from this source. It is possible that arbitrage opportunities could provide possibilities for insider dealing if the identity of the CfD holder is not disclosed. But this situation would probably be caught by the Market Abuse regime. It is also possible that uncertainty (as to the underlying intention) caused by the sale (or purchase) of stock to hedge CfD contracts could result in speculation and price volatility. But disclosure of intention is not covered by the existing MSN requirements. By the same token, a generalised disclosure regime would equally not reveal any information about the intention of the CfD holder in relation to their strategy.

5.14. More generally, the main purpose of the MSN regime itself is not to ensure disclosure of trading strategies or portfolio positions. To the extent that these are revealed by the disclosure regime, it is as a by-product of rules designed to focus on corporate ownership and voting rights.

5.15. In relation to voting rights, the hypothesis that our evidence should test would be broadly as follows:

(i) the current DTR (and Companies Act) regime is aimed at voting rights;

(ii) CfDs essentially share the same characteristics and are used in the same way as shares, which do carry voting rights; so

(iii) CfDs should be subject to the same disclosure requirements.

5.16. Our review of the academic evidence considering the effect of shareholder notifications on price formation suggests that MSN disclosures are of value to the market and contain information that investors use in pricing issuers' shares. This appears also to happen in practice, as shown by our analysis of MSN data. This is particularly important in the context of possible takeover situations, where lack of disclosure of significant positions built up in anticipation of a takeover (a 'toehold') can discourage other potential bidders from entering a contest. This is because the bidder with an existing toehold will have more incentive to see the bid through to a successful result. In applying these conclusions to the issue of CfD disclosure, the key question is whether CfDs are in effect a substitute for shares so that disclosure of CfDs would bring the same benefits to price formation, takeover situations and market confidence as MSN disclosures. This would be the case where:

- CfD positions 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.

5.17. The survey carried out for us by PwC does not suggest that the policies and practices of investment banks writing CfDs do operate in these ways. In particular:

- investment banks hedge their CfD contracts to varying extents rather than one-for-one;
- according to participants in our survey, contracts are only occasionally closed out by selling the underlying shares to the CfD holder; and
- the general policy of investment banks is not to vote shares in accordance with CfD holders' requests (although they are sometimes asked to).

5.18. In addition, our review of trading volumes of CfDs referenced to the stock of an issuer which is the subject of a takeover bid shows that there does not appear to be a significant difference in the number of contracts written in the run-up to the offer and the number written in the one month after the offer period starts. Nor does there appear to be a significant build-up of CfD activity in the months ahead of an offer period. However, the value of CfD activity does increase substantially once an offer period starts (i.e. the average size of the CfDs written goes up). On this basis, the changes introduced by the Takeover Panel in 2005 appear to have addressed disclosure concerns for the most important time period.

5.19. But our survey of market participants also shows that despite the stated – and implemented – policies of investment banks, holders of CfDs do on occasion approach the writers seeking to exert influence on an undisclosed basis over voting rights attached to stock held as hedge against those contracts.

5.20. In addition, we have followed a number of recent publicly reported situations where it appears that CfDs have been used to help build up significant stakes in companies without any prior disclosure, as would have been required by the DTRs for acquisitions of shares. It is reasonably clear to us from these situations that there is, at least to some degree, a general market acceptance that stock can be delivered by a CfD writer to a holder if requested, and that these requests are made, if not always agreed to by all CfD writers. That this is now an increasingly accepted part of market practice is also shown by financial press coverage of the CfD market[5]. This has the potential to impact on market confidence.

5.21. Overall we conclude that CfDs are not in effect a substitute for the shares on a systematic basis. But there are a few instances in which they are, or might be perceived as being such. In those cases, CfDs are being used in ways which the intention of the current regulatory regime is designed to catch. Specifically, we conclude that CfDs are sometimes being used firstly, to seek to influence votes and other corporate governance matters on an undisclosed basis, and secondly, to build up stakes in companies, again without disclosure.

5.22. We have therefore concluded that we should seek to address these specific instances, which relate directly to the use of CfDs to access or influence the voting rights of the underlying shares. In other words, we have concluded that leaving the current regime as it stands is not desirable. Some action is needed.

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

Policy Framework

5.23. But as outlined above this still leaves us with a wide range of potential responses. In formulating what point along this range is appropriate we believe we should be guided by three key propositions:

- first, we are not against the use of CfDs to influence corporate actions and governance matters provided it is on the basis of disclosure (as would be the case for shares held directly);

5 For example, '*The Business*' September 2007 commented that '*the brokers and investment banks that provide CfDs also go into the market to buy or sell shares that underpin them. If they own the shares then, in turn, they own the voting rights. It may be possible to conduct a separate transaction that bestows the voting rights to the CfD investor. Alternatively, the broker may be willing to sell some actual stock to the CfD investor*'.

- second, we do see some specific 'failures' of the current regime where lack of disclosure appears to be the underlying difficulty, but these are not systematic in nature; and
- third, given these failures are not systematic, we would prefer proportionate solutions that address as far as possible the more significant concerns and do not lead to excessive 'noise' or to inconsistencies in how any new requirements are implemented.

5.24. On this basis, we propose a two-part response:

(a) first, a clear restatement of the existing regulatory regime, to make clear the extent to which certain behaviours are already caught by our rules; and,

(b) second, measures designed to require greater disclosure of CfDs in those circumstances where CfD holders are seeking to influence a company's management and strategy, or seeking to use CfDs as a basis for engaging in stakebuilding. Here, we are putting forward two separate options for consultation: a package of specific targeted measures which would strengthen the application of the existing regime, and lead to enhanced disclosure in specific circumstances (we label this 'Option 2' in what follows); and a generalised disclosure regime (which we label 'Option 3').

5.25. We have made an informed and careful evaluation between Option 2 and Option 3. We believe that we can deliver our desired outcomes through the former. But we recognise that there is an important discussion about the merit of going beyond these measures, and we address this option further below.

5.26. In the rest of this chapter we cover the following issues:

(a) **Restatement of the existing regime** (paragraphs 27-28)

(b) **Scope and definitions of new rules** applicable to both Options 2 and 3 (paragraphs 29-31)

(c) **Option 2:** proposed new rules, aggregation and threshold issues, scenarios to illustrate impact of new rules (paragraphs 32-50)

(d) **Option 3:** potential benefits, aggregation and threshold issues, interaction with Option 2, potential costs (paragraphs 51-63)

(e) **Comparison of Option 2 and Option 3** (paragraphs 64-70)

(f) **Issues applicable to both Options 2 and 3:** information to be disclosed to issuers, information to be disseminated to the market, disclosure exemptions for CfD writers, interaction with Takeover Panel requirements (paragraphs 71-84)

The existing regime

5.27. In our October 2006 statement we said that we would consider ways in which we could more aggressively enforce the existing regime. We believe that the starting point for this should be a clear re-statement for the benefit of all market participants – issuing companies, writers and holders of CfDs – of the current regime and the intentions behind it. We summarised in chapter 2 the main elements of this regime. Table 2 below sets this out in more detail, together with illustrations showing how the current regime already bites on a number of different situations which have been held out as raising problems.

5.28. The FSA continues to view combating all forms of market abuse as a key priority. We aim to maintain clean markets and to deter abuse through a combination of preventative measures and enforcement action. As part of this, it is important that the market does receive the information it needs on an accurate and timely basis. In this context we will continue to monitor proactively compliance with the DTRs. Since taking on the oversight of the major shareholdings regime in January 2007 we have been working with market participants – issuers, investors and their respective advisers and agents – in ensuring reporting obligations are understood and followed. We have previously commented that we would take a risk based approach in monitoring compliance. As with any breaches of FSA rules, failures by firms or individuals to comply with the DTRs, either in their existing or a strengthened form, could lead to appropriate enforcement action. We will also be prepared to take action under the market abuse regime against false or misleading announcements.

Table 2

Current Legislation	What the rules say	Examples of how they apply
FSA Handbook – High Level Standards	Applies to authorised firms.	
PRIN 2.1.1 R	1. A firm must conduct its business with integrity. 5. A firm must observe proper standards of market conduct.	Any firm misrepresenting its position by claiming a larger interest through CfDs that they possess or falsely claiming or implying that they have access to voting rights, or having access to voting rights without making a disclosure, where these actions were considered to be carried out in connection with a regulated activity, would be falling short of standards required by authorised firms.
Disclosure and Transparency Rules	*DTR 5 applies to persons holding voting rights in shares admitted to trading on a regulated or prescribed market*	
DTR 5.1.2	A person must notify the issuer if their holding of voting rights attached to shares exceeds 3% or exceeds of falls below one of the thresholds.	A person buys a large amount of shares, with voting rights attached. If the voting rights attaching to the shares do not benefit from an exemption, (From 5.1.3R) such as trading book, or market maker, there is a requirement to make a notification.

Current Legislation	What the rules say	How they might apply
DTR 5.1.2	CFD example 1	CfD holder has (1) no access to voting rights for duration of contract and (2) contract is not physically settled. The CfD holder only has an economic interest and has no obligation to disclose.
DTR 5.1.2 **DTR 5.2.1**	CFD example 2	CfD holder has (1) access to voting rights but (2) contract is not physically settled. The CfD holder will have to notify the issuer at the point it enters into the CfD, where it fails under the requirements of DTR 5.2.1R. When the contract is settled, it will cease to have access to the voting rights and will have to make a further notification if it has crossed one of the thresholds for disclosure.
DTR 5.1.2	CFD example 3	CfD holder has (1) no access to voting rights for duration of contract and (2) contract is physically settled If the CfD holder has a right under the CfD to have the underlying securities, the CfD holder will have to notify the issuer at the point it enters into the CfD, as it holds voting rights through a financial instrument. If there is no right to the underlying securities, there is no need for a notification until the CfD holder takes deliver of the underlying shares.
DTR 5.1.2	CFD example 4	CfD holder has (1) access to voting rights and (2) contract is physically settled The CfD holder will have to notify the issuer at the point it enters into the CfD, where it falls under the requirements of DTR 5.2.1R. When the contract is settled, it may have to make further notification in accordance with DTR 5.7.1.

Current Legislation	What the rules say	How they might apply
DTR 5.1.2	CFD example 5	CfD holder has (1) no access to voting rights for duration of contract and (2) contract is not physically settled. The Original contract is varied to either give access to voting rights or physical settlement or both. Initially there is no disclosure required. If the nature of the contract changes to become a financial instrument that gives the CfD holder access to voting rights then that would trigger a requirement to notify the issuer.
DTR 5.1.3/5.1.4	Shares held by a market maker, up to a holding of 10% [5.1.3R(3)], are not required to be notified to an issuer as long as the market maker **does not intervene in the management of the issuer** [5.1.4(1)(b)]	A CfD holder instructs the CfD writer, who holds shares in the company as a hedge in its trading book or market maker account, to vote the underlying shares in a certain way. By exercising the votes on the instructions of the CfD holder the CfD writer would lose the disclosure exemption, by effectively intervening in the management of the share issuer, and it would have to disclose its interest in the underlying shares.
DTR 5.1.3 (4)	Shares held within the trading book of an investment firm or credit institution which do not exceed 5% of voting rights may be disregarded for notification purposes, provided that **the voting rights...are not exercised or otherwise used to intervene in the management for the issuer**. Again, any attempt to vote shares would negate the exemption and require a disclosure.	
DTR 5.3.1	A holder must make a notification if it holds, directly or indirectly, certain financial instruments which result in an entitlement to acquire, on the holder's own initiative alone, issued shares to which voting rights are attached.	Where someone buys a call option over shares which would give access to a notifiable level of voting rights, it would have to make a disclosure. Likewise if a CfD holder had a right under the contract to buy the shares at closure of the CfD, it would also have to make a disclosure.
Market Abuse Rules	*Applies to all market participants*	
MAR 1.8.1 Market abuse (dissemination)	Market abuse [includes] 'the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading'	Any firm misrepresenting its position publicly by claiming an interest through CfDs that they do not possess, which could have an effect on the market, could be in breach of the Market Abuse Rules.

Current Legislation	What the rules say	How they might apply
Takeover Code	*Applies to everyone*	
8.3(a)	During an offer period, if a person, whether or not an associate, is interested (directly or indirectly) in 1% or more of any class of relevant securities of an offeror or of the offeree company or as a result of any transaction will be interested in 1% or more, dealings in any relevant securities of that company by such person (or any other person through whom the interest is derived) must be publicly disclosed. Relevant securities here includes CfDs.	A person or firm has built up a significant economic interest in a company, by holding a large CfD position. The company is then involved in a takeover. If the person later deals during the offer period, either in shares or in derivatives, they will have to disclose all their interests including their CfD

Scope and definitions (Options 2 and 3)

5.29. We propose to add a new category of instrument to the existing DTR categories of shares and qualifying financial instruments. This would be a 'comparable financial instrument', which would be defined as a financial instrument having similar economic effect to a qualifying financial instrument.

5.30. We would consider a comparable financial instrument to have 'similar economic effect' if its terms are related or referenced in whole or in part to an issuer's shares. We also intend that only gross long positions should be brought within the scope of the new rules. This is because our focus is on voting rights and/or the potential for holders of economic interest to acquire the underlying shares.

5.31. The proposed new rules will apply to instruments referenced to shares that, as set out in DTR 5.1.1., are traded on a regulated or prescribed market. So the new rules will apply to CfDs relating to shares traded on PLUS (now a regulated market) and AIM (a prescribed market) as well as CfDs related to shares on the main market.

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

Option 2: Strengthening the existing regime

5.32. As indicated above we believe that there are several instances of CfDs being used in ways that the current regime does not explicitly capture. Greater disclosure has been strongly supported by issuers and investors and more recently has been recommended by the Hedge Funds Working Group (see paragraph 53 below). So we have considered some additions to the requirements contained in the DTRs to target the specific situations we have noted above, and are proposing two measures now for consultation. The first will make it clear to issuers and holders of CfDs that access to voting rights should not be claimed misleadingly or untruthfully by requiring disclosure of CfD contracts that do not comply with a number of requirements that together form a 'safe harbour'. It will also make it more difficult for them to build significant stakes in companies through CfDs on an undisclosed basis. The second would broadly mirror s793 of the Companies Act 2006 by giving companies the ability to request information from a person they have reasonable cause to believe holds an economic interest in the company's shares. These measures are set out separately in more detail below.

(i) Disclosure of CfD contracts

5.33. We are proposing to add new rules to DTRs 5.1.2 and 5.3.1 and related provisions that will require CfD contracts above a specified threshold to be disclosed by the holder to the issuer (and by the issuer to the market) unless all of the following provisions constituting a safe harbour apply (CfDs that are silent on any of them will be treated as not complying with the safe harbour):

(a) The contractual arrangements of the CfD forbid the holder from exerting influence over related shares to which the CfD writer may during the term of the contract have access.

(b) The terms of the arrangements state there are, and will be, no arrangements or understandings in relation to the potential sale of the underlying shares (or the benefit of them) to the CfD holder on or shortly after the expiry of the contract. This would include any discussion simply about the possibility of such potential sale, and 'understanding' would include any formal or informal understanding including a clear or firm expectation arising out of the circumstances. The provision would be limited to arrangements or understandings in relation to underlying stock that the CfD writer had acquired in connection with the CfD, for example, as a hedge. Therefore they would not capture unrelated ordinary course of business dealings between the parties to the contract in shares held by the CfD writer for other purposes.

For both the above, the contractual arrangements may subsequently be varied to allow the holder influence over the voting rights in the issuer or the sort of arrangements set out in (b). If either occurs, this would remove the CfD from the safe harbour and it would need to be disclosed.

(c) The provisions set out in (a) and (b) have not been breached regardless of whether they are enforceable between the parties. So regardless of whether the parties would have an interest in or the ability to enforce the terms of the CfDs a breach would mean that the safe harbour falls away.

(d) In addition, the holder must declare in writing to the CfD writer at the time of entering the contract that he does not have any intention to acquire or obtain access to shares in the issuer that the CfD writer holds, or may at some point hold, in connection with the CfD. That intention must be genuine and remain accurate for the safe harbour to be available. This means that if the holder subsequently changes their mind, a notification would have to be made as the original declaration would no longer continue to be accurate. Whilst this triggers a disclosure obligation because the safe harbour is no longer available, it may also raise questions about the reliability of the original declaration of intention in the absence of robust and convincing justifications regarding the change of intent. It may also cast doubt on the absence of an informal understanding or arrangements as to the potential scope for acquiring underlying shares from the CfD writer.

5.34. We would expect that most CfD contracts will be constructed so they qualify for the safe harbour, at least at the start of the contract, given the information we have about the purpose for which most CfD contracts are used. CfDs which do qualify for the safe harbour would not be disclosable under this provision. However, the proposed rules requiring disclosure of CfD contracts that do not comply with the provisions of the safe harbour set out above will make it more difficult for holders of CfDs to claim access to voting rights on a false or misleading basis and/or to build up significant stakes on an undisclosed basis.

> 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?

(ii) Notification to issuer on reasonable request

5.35. Although we expect most CfDs to comply with safe harbour, even where they do comply, there may be circumstances where issuers may need a supplementary tool to help them verify the identity of holders of economic interest in their company and the extent of any such economic interest.

5.36. The Companies Act 2006 already contains provisions that allow companies to seek information from persons who the company believes may be interested in its shares. Specifically, s793 enables a public company to require any person whom the company knows or has reasonable cause to believe to be interested in the company's shares (or to have been interested in the previous three years) to confirm whether or not this is the case and, if it is, to provide further information relating to the interest. These provisions also allow shareholders of the company, who together hold 10% or more of the company's shares, to require the company to issue such a request. The underlying intention is to allow minority shareholders to require the company to provide them with information in situations where the directors are not exercising their powers, where the shareholders' interests may not be fully aligned with that of the company's management, for example in a takeover. The information required to be disclosed can include (s824) whether there is an agreement between parties to acquire shares or agreement or arrangement relating to the exercise of voting rights (but this applies (s824 (2) (b)) only where the shares have subsequently been acquired). The information required is not constrained by any specified threshold in terms of the amount of interest. There is no further definition of 'reasonable grounds for belief', but if the requirement to provide information is 'frivolous or vexatious' (s795 (2)) the person to whom it is sent is not required to comply with it. The information required must be given within a 'reasonable' time as specified by the company issuing the requirement and the company is required to provide whatever information it receives available to its members and also to make it publicly available.

5.37. To the extent that CfDs do not comply with the proposed safe harbours outlined above (including the exclusion of any ability on behalf of the CfD holder to exercise influence on voting rights and the absence of any agreement or understanding to acquire shares), they would need to be disclosed. However, the company may still need to verify claims or other comment or speculation about any economic interest held in that company by a CfD holder if the CfD complies with the safe harbours, but still (later on) could give access to voting rights or be used to exercise influence over the company. The Companies Act provisions described above would not necessarily fill this gap. We are proposing, using the Companies Act provision as a model, to provide issuers with the ability to establish in certain circumstances who, over specified thresholds, holds economic interest in their shares. We propose that a CfD holder will be required to make a notification in response to a reasonable request from an issuer in relation to any CfD related to the issuer's shares over a specified threshold (see below for more detail on the thresholds).

5.38. We have considered the need to prevent indiscriminate or unjustified use of this provision by issuers and propose to set out what constitutes a reasonable request. A reasonable request would be one where the issuer knows or has reasonable cause for believing that a person has an economic interest in the issuer's shares and is not vexatious or frivolous. 'Reasonable cause' would include (but not be limited to):

(a) a direct or indirect approach by the CfD holder attempting to influence the issuer's management, claiming to have access to or control over voting rights in the company; and

(b) the issuer being aware of significant press speculation or market rumour (not instigated by the issuer itself) identifying the person to whom the request is sent as potentially interested in the shares or voting rights, or in gaining access to or control over voting rights, and the issuer has taken reasonable steps to satisfy itself that the speculation or rumour is not frivolous or vexatious.

5.39. To reinforce our intention that this provision should not be used indiscriminately, we propose to add a rule to the effect that issuers must document the grounds on which they are making a request for a notification. This could be done in a standard form that we will make available on our website. This documentation of the grounds for the notification, along with any notification from the CfD holder to the issuer, will be required to be disseminated to the market. An issuer's request is unlikely to be reasonable if the issuer has already sent a request to the same person and there has been no material change in the circumstances to warrant a further request. For example, multiple requests in a relatively short space of time based on substantially similar press speculation or market rumour may indicate that the issuer does not have reasonable cause to issue a further request.

> 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?

(iii) Aggregation and Thresholds

5.40. Under the Transparency Directive (TD) significant shareholders of a company are required to notify the issuer when its holdings cross specified thresholds. These are set at 5% point intervals from 5% to 30% and thereafter at 50% and 75%. Our implementation of the TD through the DTRs retained the previous Companies Act thresholds of 3% and every 1% thereafter.

5.41. The DTRs require that shares and other qualifying financial instruments (as set out in DTR 5.3.1) should be aggregated for the purpose of notification (see DTR 5.7.1 and List!14[6]).

5.42. This approach raises the issue of how CfDs should be aggregated and the thresholds at which they should be notified, both in respect of the disclosure of CfDs that do not benefit from the safe harbours and of the thresholds at which the notification to issuer provision should operate.

5.43. As we have made clear earlier, our overall objectives are to prevent the use of CfDs to assist unsubstantiated approaches to management and/or stakebuilding on an undisclosed basis, and to increase market transparency. Our proposed approach to the issue of aggregation and thresholds flows from these objectives. We are seeking to implement a regime that is effective and workable, and that sits within the scope of the TD and our powers. We are also seeking to avoid the disclosure of misleading or valueless information; inconsistent treatment of comparable situations; and of opportunities for 'regulatory arbitrage' so that investors with similar access to voting rights (whether through shares or other financial instruments) should have similar disclosure requirements. Finally, we also want to avoid creating loopholes.

5.44. We therefore propose that CfDs that do not comply with the safe harbours should be aggregated with instruments currently within the scope of the DTRs (i.e., shares and qualifying financial instruments in DTR 5.3.1, including CfDs that carry a formal agreement to deliver underlying shares). This should be done on the basis that these CfDs effectively provide access to voting rights and should be treated in the same way as shares and other instruments that provide this access. Aggregates of these holdings should be subject to the existing DTR disclosure thresholds (both where holdings increase over a threshold, and where they decrease below a threshold). CfDs that comply with the safe harbour provisions should be aggregated separately along with other comparable financial instruments that similarly comply. Because they do not carry actual or presumed access to voting rights there should be no aggregation of this

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6 http://www.fsa.gov.uk/pubs/ukla/list14_apr07.pdf

category with the first category. These would not be disclosed except in response to the notification to issuer provision. This is set out in Table 3 below.

Table 3

	Currently caught holdings			Aggregation under new regime
1	Shares		Currently aggregated under existing DTRs	These will all be aggregated under the new regime (Option 2)
2	Qualifying financial instruments	(e.g. call option)		
3	CfD with formal agreement to deliver the underlying	(very rare, if at all, but effectively embedded call option)		
	Newly caught holdings			
4	CfDs that are silent on access to shares [or fail to meet all the criteria for a safe harbour]	Constructive access to voting rights based on new rules		
5	CfDs Benefiting from the safe harbour	No voting rights associated so not generally disclosable	May be disclosable to an issuer making a notification request.	These will be treated as a separate 'category' under the new regime
6	Other comparable financial instruments	Treated in the same way as the instrument to which they are comparable.		Treated in the same way as the instrument to which they are comparable.

5.45. We have considered whether the same thresholds should apply for the notification to issuer provision as apply within the DTRs currently. Our view is that, as a principle, CfDs that comply with the safe harbour should generally not be disclosable. However, there are circumstances in which an issuer may need to be able to establish whether a possible CfD holder does actually hold economic interest. This is particularly important where there is significant suspicion or belief that attempts are being made to build a significant stake in the issuer through the use of CfDs on an undisclosed basis, and so, despite the presence of the safe harbour, there are grounds for considering that the CfDs may be being used to provide access to voting rights. Consistent with our objective of avoiding the disclosure of misleading information, we propose that the initial threshold for disclosure of economic interest in response to a reasonable request should be set at 5%, following the TD. After that, further disclosures should be required (again, in response to a further reasonable request) only when further TD thresholds are crossed (i.e. at 10%, 15%, etc, or when economic interests fall beneath the thresholds; for the situation where an economic interest falls below 5% the response from the CfD holder would be 'no notifiable interest). It is possible that the notification to the issuer may be a confirmation that in effect the position is the same (i.e. the holding of economic interest is in the same band as previously, even if it has moved over a threshold and subsequently fallen back to the same band).

5.46. We have considered whether in responding to a reasonable request from an issuer a CfD holder should include all economic interest across the two categories of instruments, whatever form it takes (i.e. shares, CfDs that do not comply with the safe harbours as well as 'pure economic' CfDs). We think that the notification to issuer provision should apply only to 'pure economic' interests. Holdings of shares and CfDs that are silent on any of the provisions constituting the safe harbour ('silent CfDs') will be disclosable under the new rules, and aggregation across the categories would lead to double-counting.

5.47. This approach to aggregation and thresholds is illustrated through some examples set out in Table 4 below (assuming a notification to issuer threshold of 5%).

Table 4

	Disclosable holdings	**Safe harbour holdings**	**Disclosure Obligation**
Example 1	2% Shares	2% Economic interest CfD	No disclosure obligation.
Example 2	2% shares 2% silent CfD	None	'Silent' CfDs deemed to have access therefore aggregated. Disclosure of 4%.
Example 3	2% shares 2% silent CfD	3% Economic interest CfD	Disclosure only of 4% (aggregated shares and silent CfD).
Example 4	None	6% Economic interest CfD	Disclosure of 6% only in response to issuer notification request.
Example 4a		6% Economic interest CfD (already disclosed under issuer notification request) Plus 2% Economic interest CfD	Response to issuer notification request would reveal no further disclosure.
Example 4b		6% Economic interest CfD (already disclosed under issuer notification request) Plus 5% Economic interest CfD	Disclosure of 11% only in response to issuer notification request.
Example 5	2.5% silent CfD	6% Economic interest CfD	Disclosure of 6% only in response to issuer notification request.
Example 5a	2.5% shares	6% Economic interest CfD	Disclosure of 6% only in response to issuer notification request.
Example 6	2.5% silent CfD	4% Economic interest CfD	No disclosure (both holdings below threshold).

Q10 Do you agree with our proposed approach to aggregation and thresholds for Option 2?

(iv) Disclosure of purpose

5.48. We have also considered the possibility of adding a new rule to DTR to the effect that a CfD writer that acquires shares to hedge a CfD contract (or disposes of shares upon closing out the CfD position) should make a disclosure in relation to the hedged shares stating that the purpose of the acquisition (or disposal) was to hedge a derivative contract. This could give issuers more knowledge as to what percentage of their shares is being held as a hedge at any one time.

5.49. However, the costs for investment banks in complying with this rule could be high, as generally their systems are not configured to capture the underlying rationale for individual transactions and to identify those which have been carried out for the specific purpose of hedging CfDs. In addition, feedback from issuer stakeholders has been that such a provision would in fact be of limited value to them. So we have decided not to take this forward.

(v) Effect of new rules

5.50. We set out in Table 5 below a number of scenarios to illustrate the way in which we intend the provisions set out above to operate.

Table 5

Scenario	New Rule	Effect
1) A CfD Holder enters into a CfD with CfD writer for 5% of the shares of Company A. At this point the holder meets all the requirements for the safe harbour. At a future point in time they decide to try and get hold of the underlying shares from the CfD writer, passing through some or all of the following stages: • The holder thinks about whether they would like to acquire the underlying shares • The holder contacts the CfD writer to explore the possibility of acquiring the underlying shares • The holder decides they will try to acquire the underlying shares • The holder, relying on its long term relationship with the CfD writer, is confident of being able to acquire the shares if he asks • The holder asks the writer to deliver the underlying stock on or shortly after close out of the CfD	Safe harbour requiring declaration of intention not to acquire	At **each bulleted stage of the process** the holder should be asking themselves the question whether their genuine intention, not to acquire, or otherwise obtain access to shares in the issuer continues to be valid. If they no longer have the intention not to acquire, **they must think about making a disclosure.**
2) CfD Holder enters into a CfD with CfD writer for 5% of the shares of Company A. The holder is aware that the CfD writer is likely to hedge this by buying 5% of the shares. CfD Holder wishes to buy the shares at the expiry of the CfD. There is nothing in the contract giving CfD Holder the right to do this, but nothing preventing it either. Currently CfD Holder would not have to disclose its interest under 5.3.1.	**Disclosure of CfDs, which are assumed to have access to voting rights, unless the contract meets the safe harbour requirements**	Under the new rules on disclosure of non-'safe harbour' CfDs, the CfD Holder would have to disclose to Company A that it had entered a CfD for 5% of the shares of Company A, unless the terms of the CfD met the criteria for a 'safe harbour'.
3) A CfD Holder calls up Company A claiming to have a significant interest in the company through CfDs. The CfD Holder wants to talk to the senior management at the company to discuss strategy. Company A currently has no way of checking whether the CfD Holder has a real interest and how big it is.	**Investor triggers disclosure**	If the CfD Holder does have a CfD, then if it is currently a purely economic interest it may still be within the safe harbour, and not need to be disclosed. However, by approaching Company A, it gives the company a reasonable basis to ask the holder whether it has an economic interest in Company A, and the CfD Holder would have to disclose to that company, and through the company to the market.
4) There is significant press speculation that a hedge fund holds a large interest in a company through a CfD holding. The interest may benefit from the safe harbour rules, and appears not yet to be disclosable. Currently the company has no real information about the nature and size of the holding.	**Investor triggers disclosure**	Under the new rules on Notification to issuer, Company A would be able to formally ask the alleged CfD holder whether it has an economic interest in Company A, and CfD Holder would have to disclose to that company, whether or not he has any economic interest in the shares, and what percentage of the voting rights that economic interest would represent. The company would then disclose to the market.

Option 3: General Disclosure regime

5.51. We believe that the measures in Option 2 represent a targeted and effective response to the specific issues that we are seeking to address. Indeed, in comparison to the Option 2 we set out last October, we are in fact going further than had been envisaged. We are introducing new requirements for disclosure of CfDs, and giving issuers new tools to 'flush out' notifications by holders of economic interest in their shares in specific circumstances.

5.52. However we recognise that some stakeholders would prefer to see a general disclosure regime whereby all positions of economic interest would be disclosed to the market above a specified threshold, irrespective of the holder's intention. In effect, this would be the equivalent of extending the Takeover Panel's current regime, which requires disclosure (above a 1% threshold) of (long) interests in derivatives and options in respect of or referenced to securities during an offer period.

5.53. In a recent survey of some (mainly FTSE 250) 70 UK quoted companies[7] the Investor Relations Society found very strong support for an extension of this sort (96% supported the amendment of DTR 5 to include CfD positions). In addition, we note the consultation document on best practice standards[8] of the Hedge Fund Working Group (HFWG) in relation to shareholder conduct and derivative positions. In particular:

'The HFWG acknowledges that companies have a right to know who owns them or who has an ability to easily obtain significant voting power. Indeed, members of the HFWG would welcome higher levels of disclosure.

However, the voluntary adoption of enhanced disclosure requirements by hedge fund managers (or any other particular sector of the market) would cause distortions in the market place because they would not apply to all market participants but merely to hedge funds.

Therefore, the HFWG recommends that regulators take action to introduce a regime (similar to that of the Takeover Panel in the United Kingdom applicable during takeover offer periods) requiring notification of 'economic' interests in shares held via instruments such as CFDs.'

(i) Benefits

5.54. The possible benefits of such a regime would be:

- greater transparency for issuers: companies would have a clearer idea of who holds key interests in them and therefore who their potential shareholders are, leading to more effective communication with investors, shareholders and the market;
- greater provision of information to the market overall, leading to less asymmetry of information, reduced volatility and lower cost of capital;

7 http://www.rdir.com/survey/survey.html?SurveyID=164123&ReportID=-1&pw=d786

8 The Hedge Fund Working Group, chaired by Sir Andrew Large, was established in June 2007 'to review existing standards for the hedge fund industry and make recommendations for strengthening where appropriate'. Its report can be found at: http://www.hfwg.co.uk/sites/10085/files/HFWG%20Paper%20Part%202%20Final.pdf p47

- relative simplicity: the disclosure requirements would be more general in scope and nature and so easier to comply with than specific rules set out in Option 2 based on the structure of individual contractual arrangements and the underlying intentions of the parties involved; and
- clearer alignment with the Takeover Panel regime

5.55. As we have set out above, we are not persuaded that there is a strong justification based on clear market failure for the greater provision of information about CfDs to the market as an end in itself. However, a general disclosure regime could be an alternative approach to the specific problems that we have identified in relation to the exercise of influence and undisclosed stake building, provided it could be implemented on a proportionate basis. We are therefore putting this Option for consultation alongside the consultation for Option 2.

5.56. This Option raises a number of questions. First, where should the thresholds for disclosure be set? Second, as with Option 2, how should different CfDs be aggregated and should economic interest be aggregated with existing holdings subject to the current DTRs? Third, should the specific proposals outlined above for Option 2 be maintained alongside a general disclosure regime?

(ii) Thresholds

5.57. We consider that as far as possible the treatment of CfDs in a general disclosure regime for threshold and aggregation purposes should follow the same principles as set out above for Option 2. In relation to thresholds, our objective remains to position any disclosure requirement such that only significant positions are caught and unnecessary 'noise', which could lead to market confusion, is avoided. On this basis, we propose again to follow the TD thresholds, i.e. for disclosure where holdings of economic interest cross thresholds (both where holdings increase past a threshold, and where they decrease below a threshold) set at 5%, 10%, 15% etc. Although we propose setting the initial threshold at 5%, it could be set higher, for example at 10% or even 15%.

(iii) Aggregation

5.58. In relation to aggregation, we would propose a broadly similar approach as set out for Option 2. In other words, there would be two separate 'categories' for disclosure. However, because the focus of Option 3 would be on economic interest, there would be no need to differentiate between those CfDs that do exclude access to voting rights and those that do not. So (nearly) all CfDs would be aggregated in one category, separate from shares, qualifying financial instruments (and those CfDs with an embedded option on the delivery of the underlying shares). Consistent with the approach set out for Option 2, there would be no aggregation across the categories, as the existing DTR requirements would continue to operate.

Q11: Do you agree with our proposed approach to aggregation and thresholds for Option 3?

(iv) Interaction with Option 2

5.59. The third issue is whether, if Option 3 were implemented on the basis proposed, the Option 2 measures put forward to strengthen the existing regime should also be maintained so that CfDs not complying with the safe harbours should continue to be disclosed if they cross the DTR thresholds and issuers should have the ability to request a notification from a CfD holder over a 5% threshold. Our view, and the basis on which we are consulting, is that Option 2 and Option 3 should be self-standing alternatives. A combination of Option 2 and Option 3, which would entail disclosures at different thresholds, would in our view be confusing and disproportionate.

5.60. In fact, the substantive difference between Option 2 and Option 3 (at a 5% threshold) is relatively limited, as Table 6 below illustrates. If the Option 3 disclosure regime were adopted, there would only be a gap - as indicated in the shaded line below - in respect of CfD holdings between 3% and 5% not complying with the safe harbours. The loss of this information, disclosable under Option 2, would seem an acceptable response to avoid requiring disclosure of all purely economic 'safe harbour' interests between 3 and 5%.

Table 6

CfD that would meet the Option 2 criteria of a Safe Harbour	Percentage holding	Disclosure required under Option 2	Option 2 Potential notification to issuer?	Disclosure required under Option 3?	Comment
Yes	0-3%	No	No	No	Below threshold in any case
Yes	3-5%	No	No	No	No notification to issuer below 5%
Yes	5%+	No	Yes	Yes	Automatic general disclosure in Option 3
No	0-3%	No	No	No	Below all thresholds
No	3-5%	Yes	Yes	No	Possible disclosure gap at 3%-5% level in Option 3
No	5%+	Yes	Yes	Yes	

(v) Costs of Option 3

5.61. However the key issue in relation to Option 3 is whether it is in fact a proportionate response to the issue of voting rights. We summarise here our analysis of the potential costs of Option 3 – more detailed cost-benefit analysis for both Options 2 and 3 is set out in Annex 1.

5.62. In assessing the potential costs for a general disclosure regime we have considered the direct costs to CfD holders, principally banks and hedge funds, and others (CfD writers, issuing companies and the FSA) in terms of one-off (systems set-up etc) and on-going costs. There will also be indirect costs for these market participants. We have made a number of assumptions, principally in relation to the disclosure threshold (5%), and the increase in the number of disclosure that would be required (about 20%, taking into account the experience of the Panel regime, and also of the impact of extensions of the disclosure regime in Switzerland).

5.63. Using this broad framework, we estimate that the direct set-up costs to banks and hedge funds would be of the order of £20-50million, and on-going costs would be about £1.5million annually. The potential indirect costs of a general disclosure regime are extremely difficult to quantify. Requiring disclosure of all significant CfDs could in particular have a very significant impact on their business model and strategy with consequent effects on their profitability and even their choice of business location. In addition, increased disclosure requirements could lead to a reduction in the numbers written, and/or the imposition of artificial limits on position to avoid disclosure. This could damage liquidity both for CfDs and for underlying shares, with consequent effects on the ability of companies to raise capital.

Comparison of Option 2 and Option 3

5.64. We believe that Option 2 allows us to strengthen the existing regime in a targeted and cost-effective way that would deliver precise tools for issuers to use in the specific circumstances that are of most concern to them. Requiring disclosure of CfDs that do not meet stringent safe harbour requirements, including explicit preclusion of the holder from exercising or seeking to exercise influence would make it significantly more difficult for holders of CfDs to claim the ability to access voting rights when they do not have that ability. In addition, any CfD holder who has or develops the intention to use their CfDs to build up a substantial stake in a company would be forced to disclose their interest at any level above 3%. And providing a mechanism equivalent to s793 of the Companies Act 2006 would allow issuers to 'flush out' holders of economic interest in a targeted and precise way. By focussing on addressing the issues surrounding the use of CfDs to access or influence voting rights we believe that market confidence generally will be enhanced.

5.65. The framework of rules to deliver this may on the surface appear to be more complex than for a general disclosure regime. But this should not be over-estimated, especially as we anticipate that most CfD writers and holders will want to embed their current practice into the contractual arrangements in order to take advantage of the safe harbour, while the remaining 'notification on issuer's reasonable request' provision is of itself no more complex than the existing s793 power in the Companies Act 2006.

5.66. In contrast to the potential costs of a general disclosure regime, Option 2 would carry minimal direct and on-going costs and may not risk the more far-reaching negative market effects carried by Option 3.

5.67. The alternative approach is to introduce a regime that would require the disclosure of all economic interest above a specified threshold in shares held through CfDs and other derivatives. To be consistent with our objective of capturing the more significant instances we have suggested a threshold of 5% rather than 3% for such a regime and also propose that this threshold should operate separately from that for shares – i.e. there would be no aggregation across the two categories This would have the benefit of providing greater transparency for issuers and for the market at least in terms of who holds economic interest in them and therefore who their potential shareholders are. It would also potentially help reduce some of the price volatility that may be caused by information asymmetries. It would be consistent with the requirements of the Takeover Panel in terms of scope, and as a 'one size fits all' approach would be relatively simple to comply with.

5.68. This approach would carry costs that need to be carefully evaluated. These are not just the direct initial and on-going costs for market participants but also, and perhaps as importantly, the indirect costs that could impact on all users of the market. Requiring all significant economic positions to be disclosed could damage the liquidity of the CfD market and therefore that of the underlying equity market. This could raise the cost of capital for issuers. The first question is therefore whether these costs are considered to be proportionate to the scale of the market failure that we have identified.

5.69. There is another point that should be considered, particularly from the perspective of the issuers. While a 'one size fits all' approach would provide a greater breadth of information that would be delivered automatically to issuers and to the market and might be attractive from the point of view of relative simplicity, it would not be a specific tool that issuers could use at their discretion. In addition it would not provide any information about the underlying intention of holders' of economic interest.

5.70. We nevertheless recognise that Option 3 is a valid alternative approach provided it was considered proportionate. We are therefore consulting on this an alternative to Option 2. We have considered whether a combination of Options 2 and 3 might be desirable, but for the reasons set out we do not believe that this would be effective or proportionate. We would therefore welcome the views of respondents on the balance of argument between Option 2 and Option 3.

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

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

Further issues applicable to both Option 2 and Option 3

5.71. There are several other issues that apply equally to Options 2 and 3. These are covered below. Two of these relate to the integration of these Options into the current DTRs. Here the general principle that we are aiming to follow is that the requirements currently set out in DTR should as far as possible be used as the structure for incorporating these Options.

(i) Information to be disclosed to issuer

5.72. DTR 5.8.2 sets out the information that should be notified arising from the holdings of certain financial instruments in accordance with 5.1.2. We intend that the notifications would be required for:

(a) CfDs not complying with the safe harbour and above the specified threshold (Option 2);

(b) notification to issuer on reasonable request (Option 2); and

(c) the general disclosure requirement in Option 3;

with the extra requirement that in the case of a notification to issuer on reasonable request the information should include the reasons given by the issuer for sending the request.

(ii) Information to be disseminated

5.73. Similarly, we intend that notifications made to the issuer under any of these new rules should be disseminated in accordance with the provisions of DTR 5.8.12. But any response indicating that there was no notifiable interest would not need to be disseminated.

> Q14: Do you agree with our view on what information should be disclosed to the issuer, and how that information should be disseminated?.

(iii) Disclosure Exemptions for CfD Writers

5.74. The DTRs contain exemptions for voting rights attached to shares held on a trading book (5%) or a market maker account (10%). These voting rights can be disregarded for disclosure purposes under DTR 5.1.2R. It would be expected that many CfD writers (that is someone writing a CfD in a client serving capacity) will be able to take advantage of the trading book or market maker exemption for shares in one of two ways.

5.75. First, those who write long CfDs and then hedge with the underlying stock will benefit from the DTR exemption by not having to declare long positions in the underlying stock below the exemption thresholds.

5.76. Second, where a CfD writer writes a short CfD for a client, it effectively takes a long CfD position itself. Therefore a bank writing several short CfDs could find itself with a long CfD position, representing a potentially disclosable interest but because it would be treated as an indirect holding of the underlying voting rights, the trading book exemption may apply to such a bank acting in that capacity. This seems an appropriate outcome given that it is questionable as to whether the disclosure of the long CfD position by the short CfD writer provides valuable information to the market. The short position CfD holder may be taking the short position to hedge an underlying long equity position that may have already been disclosed. A second disclosure of the long CfD position could therefore lead to double disclosure.

5.77. In any case, this second situation should only be an issue under Option 3 as under Option 2 firms writing a short CfD (and therefore being left with a long CfD) in a client serving capacity would be able to take advantage of the safe harbour provisions, since there is no access to voting rights or underlying shares. In addition the thresholds for disclosure under Option 3 only starts at 5%. Also, under Option 3, CFDs will not be aggregated with instruments disclosable under existing DTR rules, which will mean that in practice there should not be a burdensome disclosure obligation.

5.78. It should be noted that under rule 8.3(d) of the Takeover Code, the dealing disclosure requirements of rule 8.3 (a)-(c) do not apply for "*recognised intermediaries acting in a client-serving capacity*". Note 9 on rule 8 makes it clear that if a recognised intermediary (RI) "*deals in relevant securities other than in a client-serving capacity*" that is, on its own account, it must where appropriate disclose the relevant interests. This rule makes sense for offer periods, as otherwise trades done in a client serving capacity and proprietary trades would potentially have to be disclosed together. However under Option 3, interests would only be disclosable when voting rights cross the relevant thresholds (at 5%, 10% etc.). Therefore the number of disclosures required should be much lower, and there is no need for a general RI exemption.

(iv) Interaction with the Takeover Panel regime

5.79. A key issue for market participants will be the interaction of these proposed rules with those of the Takeover Panel during offer periods. We believe that market participants would want to avoid as far as possible the risk of duplicative disclosure requirements that may arise for firms having to comply with two sets of rules during such periods.

5.80. There are broadly two ways of achieving this 'dove-tailing'. The first would be to state in our proposed new rules that the (DTR) requirements do not apply if the information regarding the same holdings or dealings has already been publicly disclosed pursuant to the Panel's rules even if to a different level of detail (see below). The second would be to 'switch off' the DTRs when an offer period begins. Our preference would be for public disclosure pursuant to the Takeover Code to be sufficient to mean that compliance with the DTRs was not necessary, as we believe that this would be easier for firms to comply with.

5.81. In terms of the detailed information that would be disclosed, there are a number of differences between the Panel's requirements and those set out in DTR (5.8.2), some where the DTR requirement goes further than the Panel's, and some where the Code requires more disclosure. These differences would result for either of the approaches noted above. The main differences where the DTRs would require disclosure that is not required under the Code are:

(a) notification of the resulting holding in terms of voting rights, so in an offer period an investor/issuer would need to work out the holding itself from the public information and the DTR information already notified;

(b) disclosure of the chain of controlled undertakings through which the instruments are held (under the Panel's rules the focus is simply on the owner/controller and the person dealing).

5.82. One other difference would be the denominator used to calculate the percentage of voting rights. The DTRs, based on the TD, require use of the disclosure by the issuer, (to be made by the issuer at the end of each month in which the number of voting rights change). The Code requires use of the voting rights in existence at the time of the dealing. We do not believe this would present a real problem, and instances of this are rare. In any case, where there would be a difference, the denominator required by the Code would provide accurate information on the percentage of voting rights held.

5.83. As noted above, our preference would be for effective dove-tailing of the DTR and Panel requirements. We do not consider that having slightly different disclosures during an offer period above would significantly impact our overall objectives and that this would be preferable to imposing a dual reporting regime on firms. In stating this preference we emphasise that no implication should be inferred that the Takeover Panel would in any way be responsible for monitoring compliance with our rules, or for initiating or taking any enforcement action in respect of any non-compliance with them.

5.84. It would also of course be possible to leave the two sets of requirements operating alongside each other, as is already the case in relation to shares. We would welcome the views of market participants on whether this would be practicable.

Q15: Do you agree with our proposal that we should seek to avoid as far as possible duplication of disclosure?

Q16: Do you agree with our approach that disclosures pursuant to the Code would negate the need for additional disclosures under the proposed CfD disclosure regime?

Conclusion

5.85. We have set out in this Paper the background to the current CfD market, the ways in which CfDs are being used to meet a wide range of market needs and the regulatory framework that governs disclosure requirements. Taking the concerns of issuers and investors as a starting point we have described a number of potential market failures that might arise when CfDs are used without disclosure. These are principally inefficient price formation, an ineffective market for corporate control and diminished market confidence. In theory, these could be linked either to the 'pure' economic interest attached to CfDs or to the link between CfDs and the voting rights that attach to the shares to which the CfDs are referenced.

5.86. One of our key objectives has been to move away from the largely anecdotal nature of the discussion that has taken place to date. We have done this by carrying out a number of projects to try to establish the extent to which the theoretical market failures can and do occur in practice, and why. In particular we have sought to answer the following questions:

- What is the evidence that the *'pure' economic interest* of CfDs causes market failure?
- In relation to voting rights, what does the theory tell us about the potential impact of MSN disclosure on price formation, takeover situations and corporate governance?
- What does the empirical evidence tell us about what happens in practice, and how far can these lessons be applied to the issue of disclosure of CfD positions?
- How far do the policies and practices of CfD writers allow scope for the sorts of concerns that the issuers have raised, and the market failures that these suggest, to occur in practice?
- To what extent are the failures that do occur caught by the existing regulatory regime, including in particular that of the Takeover Panel?

5.87. The broad conclusions that we draw from this analysis are that:

- lack of CfD disclosure would be a cause of market failure if CfDs are in effect a substitute for shares; and
- the evidence that we have collected suggests that the overall this is not the case, but even so it is clear that there are some elements that are 'slipping through the net', specifically with regard first to seeking to influence on an undisclosed basis corporate decisions or governance through claimed access to voting rights and second to building up significant stakes in companies through CfDs, again without disclosure.

5.88. We have therefore concluded that we should take action now to address these failures. We propose to do this through increasing the disclosure requirements on CfDs either in specific circumstances or as a general requirement.

5.89. The key question is: what is the most effective and proportionate way of addressing this market failure arising from voting rights given that it occurs on a relatively limited basis and in specific situations? We believe that Option 2 meets our objectives of providing a proportionate and targeted response to the market failures that we have identified in a way that is consistent with the principle that CfDs are a legitimate way of exercising influence on a disclosed basis. But we would welcome the views of respondents on the relative costs ad benefits of the alternative of a general disclosure regime and on this basis have included draft rules to implement Option 3 as well if that is considered to be preferable to Option 2.

Cost Benefit Analysis of the proposals set out in the Consultation Paper

Introduction

1. A cost benefit analysis (CBA) assesses the economic costs and benefits of a proposed policy. When proposing new rules or general guidance on rules, we are obliged (under section 155 of the Financial Services and Markets Act 2000) to publish a CBA, unless we think there will be no significant increase in costs. The CBA should contain an estimate of the costs and an analysis of the benefits, arising from the proposals. We seek to give quantitative estimates of the costs, where possible, unless the costs are of minimal significance.

Baseline and Methodology

2. The CBA is a statement of the differences between the baseline – the current position – and the position that would arise if the proposed changes to our rules and guidance are implemented.

3. This CBA is informed by:

   a. a review of the literature on major shareholding notifications (MSN);

   b. an empirical study of the impact of MSN;

   c. an extensive survey of the practices of the some of the most active CfD issuing investment banks and other market participants; and

   d. a study of the level of CfD trading activity inside and outside of takeover periods for selected shares.

   In addition, we have already consulted certain market participants, including CfD writers and companies, trade bodies and other relevant market participants, on the proposals covered in the CBA.

4. It should be noted that this CBA uses the term 'CfD' to refer to all derivative instruments whereby the contract holder has an economic interest in the underlying voting shares.

Cost Benefit Analysis

5. Our CBA evaluates the incremental impact of our proposed policy options – relative to the current regime – on the following key market participants:

   a. CfD writers;

   b. CfD holders;

   c. companies admitted to trading on a regulated market or a prescribed market ('companies'); and

   d. investors.

6. In particular, it focuses on the incremental compliance costs that these parties may incur, as well as any other indirect costs or benefits that may arise under our proposals. It also highlights the direct costs to the FSA (e.g., of monitoring and enforcing) that arise under each option. Compliance costs are those necessary to ensure compliance with our rules and regulations. Incremental compliance costs derive from, for example, additional staff time or systems changes needed to satisfy new rules. Indirect costs and benefits relate to, among other things, the effects (positive or negative) on competition or prices in a market.

7. As set out in chapter 5, this CP considers three principal policy options to address the problems relating to the non-disclosure of CfDs:

   a. maintain the content and application of the current regime;

   b. strengthen the application of the current regime and extend it to:

      i. require disclosure of CfDs that do not benefit from the 'safe-harbour' i.e., those CfDs (a) that allow the CfD holder to access the voting rights of the shares held in hedge by the CfD writer; or (b) that pre-arrange the sale of the underlying shares to the CfD holder; or (c) where the CfD holder forms a genuine intention to acquire or otherwise obtain access to the shares held in hedge ; and

      ii. require persons, on receiving a reasonable request from a company, to notify that company of any CfDs referenced to the company's shares above a specified threshold that they hold. The company will then be required to make public the response;

   c. extend the current regime to include the disclosure of all CfDs (i.e. Option 2(i) but without the 'safe harbour').

8. The CBA below focuses on evaluating the incremental costs and benefits of Options 2 and 3.

Option 2

9. Option 2 places emphasis on strengthening the current regime through two distinct proposals. While each is evaluated separately below, Option 2 should be seen as an overall package.

Option 2: Disclosure of CfDs with access to voting rights

10. This consultation paper proposes that CfDs (at or above the 3% threshold) should be disclosed by the CfD holder unless (at the time the CfD is entered into) the CfD qualifies for 'safe harbour' status. To qualify for 'safe harbour' status, a CfD must (a) explicitly exclude access to voting rights by the CfD holder (i.e. the CfD writer will not take instructions from the CfD holder as to how the hedged shares should be voted); (b) the CfD writer and the CfD holder agree not to enter into pre-arrangements in relation to the sale of the hedged shares to the CfD holder; and (c) the CfD holder declares to the CfD writer that he has a genuine intention not to acquire the underlying shares from the CfD writer. If, after entering the CfD, the conditions for 'safe harbour' status are no longer met, i.e. the contract is varied to allow the CfD holder access to the voting rights or the CfD holder forms an intention to acquire the underlying shares, a disclosure obligation will be triggered. In accordance with the notification and disclosure regime currently set out in DTR 5, the new rule would require the CfD writer to make a notification to the company and the FSA and the company would then disclose the information contained in the notification to the market.

Compliance costs

11. Since most CfDs currently do not provide access to voting rights or allow for pre-arrangements, we anticipate that few CfD holders will need to make disclosures under this rule. Moreover, the vast majority of CfD holders use CfDs solely to gain exposure to price movements of the underlying shares and accordingly would not have any intention to acquire any shares used to hedge. Accordingly, we estimate that there will be very few disclosures that will be made pursuant to the new rule. However, for those CfDs that do allow access to voting rights or allow for pre-arrangements, or where the CfD holder forms an intention to buy the underlying hedged shares, we believe the costs to CfD holders of making the requisite notifications will be small. This is because very few notifications will need to be made and accordingly they can be dealt with under manual reporting, without requiring any extensive systems changes. To make a notification, a CfD holder would use the TR-1 form in electronic format and would send it to both the FSA and the relevant company. Costs to CfD holders of having to use this form are expected to be minimal.

12. There will also be small incremental costs to companies that receive notifications from CfD holders (about CfDs in excess of the 3% threshold that do not qualify for 'safe harbour' status). In this case, companies will be required to make disclosures to the market about the CfDs of which they have been notified. However, the costs to companies is expected to be minimal as the number of notifications they would receive is, based on our understanding of market practices, expected to be small. In addition, they will be able to use existing systems to make disclosures to the market. As with existing shareholder notifications, we are not proposing to mandate the format in which issuers should submit notifications to a Regulatory Information Service ('RIS'). Therefore, the options available to an issuer upon receipt of a major shareholding notification include:

a. forward the TR-1 form to a RIS;

b. forward the information on an electronic version of the TR-1 form, possibly obtained from their chosen RIS provider; and

c. make the announcement in a free-text format.

13. The cost of making a RIS announcement ranges from £12.50 to £50. We expect that the vast majority of CfDs will be able to take advantage of the 'safe harbour' and thus will not be disclosable. We anticipate that the number of CfDs that will not be able to take advantage of the 'safe harbour' will number around 10 a month, at the very most. Accordingly, the direct costs of the new rule should be minimal – i.e. in the region of £6,000 a year for the notification costs. In addition, processing of this information will require compliance departments to spend additional time on this. We estimate this to be 1-2 hours per announcement. Staff in compliance departments might also need some training to correctly apply the new rules although we do not expect these costs to be substantial. Therefore we would not expect the total annual cost to exceed £20,000.

14. We also expect that the vast majority of CfD writers and holders will want to enshrine current practice into the contracts in order to ensure that the contracts are able to take advantage of the 'safe harbour' status. We expect that the cost to CfD writers and holders of including in CfDs clauses regarding access to voting rights and pre-arrangements will be minimal.

Benefits

15. The proposal will help address the practice of CfD writers voting on behalf of CfD holders to the limited extent that this occurs. Requiring disclosure of CfDs that allow access to voting rights may benefit market confidence by reducing uncertainty as to whether CfD writers vote on behalf of CfD holders. Thus, to the extent that a particular CfD will allow the CfD holder access to the voting rights or a sale of the underlying shares is intended, subject to informal understanding or arrangement, the market will be informed of the CfD. This should reduce the market speculation that currently exists regarding the motivations of CfD holders. Additionally, the proposal may prevent side-stepping of the existing requirements.

16. While this proposal should provide greater market certainty on voting practices through CfDs, it will not prevent CfD holders from accessing voting rights either (a) during the CfD contract; or (b) upon closing out the contract with physical settlement or going directly to the market to buy the underlying shares. In all cases a disclosure will be required with access to votes through route (b) being disclosed under the existing MSN regime.

Effects on quality/quantity of products offered

17. We have considered whether there will be any effects on the supply of and demand for CfDs and take the view that any effects will be minimal. The vast majority of CfDs would not need to be disclosed and accordingly, there should be no effects on the range of CfDs offered by CfD writers. There may be a small effect on the

purchase of CfDs by holders. This is because currently, a very small percentage of CfD holders regard CfDs as instruments with which they can build up a stake in the company through stealth. However, the proposed rule will mean that such stake-building will have to be disclosed. This may mean that CfDs become less attractive to such investors. However, since the vast majority of CfD holders do not purchase CfDs for such purposes, the overall effect on the CfD market will be minimal.

Costs to the FSA

18. We anticipate that the costs of monitoring compliance with the proposed rule will be minimal.

Option 2: Notification on reasonable request to issuer

19. The 'notification on reasonable request' proposal allows companies to verify any claims by a hedge fund or other market participant of having an economic interest in the shares. Under the proposed rule, a company will be able to send a request to a person whom the company knows (or has 'reasonable cause to believe') to have a CfD referenced to the company's shares. The request will ask the person to confirm whether or not it has a CfD referenced to more than 5% of the company's shares (irrespective of whether the CfD is non-disclosable, i.e. it is able to take advantage of the 'safe harbour'). The company will have to set out, in the request, the grounds for its knowledge or reasonable belief that the person owns referenced CfDs. Guidance will be added to the rule setting out that a company may have 'reasonable cause to believe' if the person were to approach the company claiming to have access to voting shares or there was substantial press speculation or market rumour identifying the person as having significant CfDs referenced to the company's shares. A person, upon receiving such a request, would have to disclose to the company, whether or not they have a referenced CfD above a 5% threshold. Upon receiving a response to the request for confirmation (i.e. a notification), the company would have to inform the market of the contents of the notification together with the company's 'reasonable cause to believe'.

Compliance costs

20. The compliance costs to companies would be limited as they would incur these costs of their own accord which would include making the request to the alleged CfD holder and forwarding the notification to the market. Costs to CfD holders would normally arise only in the event that a CfD holder made a claim to the company of having an economic interest in the shares. In any case, we feel the costs to persons receiving requests for notification would be minimal as they would only involve a confirmation or denial of an economic interest and the relevant threshold.

21. We have also limited this power to situations where the company knows or has reasonable cause to believe that the person has an economic interest in the shares. This will avoid indiscriminate enquiries/fishing expeditions by companies, which would result in costs to other market participants.

Benefits

22. This proposal would allow companies to verify claims by hedge funds and would support the disclosure of non 'safe harbour' CfDs. We understand from companies that they are being approached by individuals claiming to have an economic interest in their shares. At present, there is no way for companies to verify such claims. This proposal would allow companies to make appropriate enquiries into such claims and then disseminate the conclusions to the market. We believe that introducing such a verification process will reduce the number of misleading statements being made in respect of significant holdings. Moreover, because there is no way of verifying whether an individual has an economic interest in the shares of a company, an individual may be tempted to make a misleading statement about such a holding. This proposal should deter individuals from making such statements as there will now be a process to check the veracity of such claims. Finally, onward disclosure to the market of any positive notification may help allay market rumour and speculation. This should promote market confidence.

Effects on quality/quantity of products offered

23. We have considered whether there will be any effects on the supply of and demand for CfDs and take the view that any effects will be minimal. A request for notification would only be triggered by a person making claims to the company to have an economic interest in the shares. Accordingly, this proposal should also have minimal impact on the supply of and demand for CfDs.

Costs to the FSA

24. The costs to the FSA will be minimal as this proposal is primarily a mechanism for information exchange between companies and persons claiming to have an economic interest in the shares of the company. Accordingly, there should be limited need for FSA resources.

Option 3: General Disclosure Regime

25. Option 3 proposes a general disclosure regime whereby all positions would be disclosed to the market above the Transparency Directive's thresholds (i.e. 5%, 10%, 15%, etc.). In contrast to Option 2 disclosures have to be made irrespective of the holder's intention. Option 3 thus is another way of tackling the lack of disclosure of voting rights, by providing more general transparency about economic interests to the market. However, on a pure CBA basis, Option 3 seems to be less proportionate than Option 2.

Compliance costs

26. Compliance costs to firms and issuers are the most substantial costs that would be incurred under the new regime. These would fall under two broad categories: up front costs involved in setting up or updating systems in order to calculate and aggregate CfD holdings with holdings in securities and qualifying financial instruments. A cost of processing additional disclosures and notifications.

Assumptions and sensitivities

27. There are a number of different constituents of the CfD holder population, including investment banks, hedge funds, and other investors. In order to estimate the size of the population, we used a combination of data from the responses to the PwC survey and reporting data from our SABRE system. We have used cost estimates from the survey response, and from our dialogue with market participants, as the basis for calculating costs across the whole population of CfD holders.

28. When looking at the expected level of disclosure of CfDs and comparable financial instruments, we considered that using the thresholds contained in the Transparency Directive would be an appropriate starting point. We have estimated that the increase in announcements (over the number required under the existing MSN regime) if the threshold was set at those contained in the Transparency Directive would be around 20%. This is based on data from the recent regulatory changes in the Swiss regime, and from figures taken from the Takeover Panel regime. There is a possibility that the increase in announcements could be higher, and at the high end the increase might represent a doubling of the existing MSN announcements.

29. The costs involved in a full disclosure regime will depend upon the thresholds at which disclosures are required. The costs given are based on the assumption that we use the disclosure thresholds contained in the Transparency Directive. However these costs could be reduced if the thresholds were set at a higher level.

Upfront costs

30. The upfront costs to CfD holders could be substantial. The most significant cost in this would be systems costs, which might vary widely across the population of CfD holders. One category of CfD holders are CfD writers. Some of the CfD writers are also significant CfD holders. These firms are mostly large banks. An indication for their systems costs can be obtained from the estimates for replicating the Takeover Panel regime given to us by CfD writers in the survey carried out by PwC (see Annex 4). Three firms actually gave cost estimates for this systems upgrade, which ranged from minimal to £5m-10m per firm. We expect only a small number of firms (i.e. less than 10) to fall into this category. Thus for these CfD holders, we would expect total system costs to be between £15m and £30m.

31. Systems requirements for other CfD holders might be different. Based on data we have of CfD activity during offer periods, we would expect hedge funds to be the most significant players in the market. They would thus be responsible for the majority of CfD disclosures. A large hedge fund gave us an estimate for upfront costs ranging from £100k to £500k. Of the estimated 300 hedge funds active in the UK, we estimate only 10-15% would be likely to be significant CfD holders and thus would have to upgrade their systems to meet the disclosure requirements. We expect that smaller CfD holders are unlikely to incur significant systems costs. Therefore the total upfront costs for other CfD holders would be somewhere between £3m and £20m. Overall, therefore, we expect the total 'up-front' cost for complying with the regime to be between £20m and £50m.

32. We would not expect to see a significant reduction in the upfront costs, even with a higher disclosure threshold, as if CfD holders have to implement system changes, these costs would not be significantly different, even if there were a lower number of disclosures. However a significant reduction in new disclosures (i.e. disclosure only over, e.g. 10%) may lead to firms opting to report manually rather than by updating reporting systems.

33. For CfD writers and issuing companies, we would not expect significant upfront costs.

Ongoing costs

34. CfD holders and companies would also face additional ongoing costs as a result of a new disclosure regime. For holders this would be the cost of analysing/monitoring positions and making disclosures to ensure compliance with the regime. For companies this would be the cost of processing and making additional disclosures to the market. There are no additional requirements for CfD writers.

35. Based on disclosure requirements in line with the existing disclosure thresholds in the Transparency Directive, we expect an increase of about 20% in the total number of disclosures. We have based this estimate on the experience of the introduction of the Takeover Panel regime and the recently implemented disclosure requirements for CfDs in Switzerland. If the threshold was set higher (say disclosures at 10% and every 5% thereafter), we would expect to see some reduction in these ongoing costs. However, we also provide cost estimates for a scenario where the new disclosures required could match the existing level of major shareholder notification disclosures (effectively a 100% increase).

36. In the table below we provide an estimate for the total additional ongoing costs for the industry. This is based on estimates for the costs of disclosure and allowing for time to process the notifications. There might also be additional costs for training, to make compliance staff aware of the new requirements. However, we think engaging into an estimation of this cost is not proportionate. In the baseline scenario (20% increase in disclosures) ongoing costs are estimated to be approximately £1.5m. As these costs are linked to the notifications (processing and disclosure costs), these costs would rise in line with the additional increase in disclosures. For the scenario with a 100% increase in disclosures we would therefore expect ongoing costs to be between £6 and £7.5m.

£Million	CfD Holders	Companies	Total
Ongoing (20% increase in disclosures)	1.3	0.2	1.5
Ongoing (100% increase in disclosures)	6.3	1.0	7.3

Costs to the FSA

37. For the FSA, we would not expect significant upfront costs. We would expect slightly increased ongoing costs, consisting of monitoring the additional announcements and monitoring compliance with the regime. The estimate would be around £25-£50,000 per year.

Indirect costs

38. One of the difficulties of producing a robust CBA in this area is the possible variations of the indirect costs. These costs, which can manifest themselves in a large variety of ways, are often difficult to predict and can be impossible to quantify. This section aims to highlight those costs, which could be more significant than the direct costs.

Costs to hedge funds and market efficiency

39. Increased disclosure of all significant CfD positions potentially has impacts on the activity of hedge funds and other investors who seek to profit from undertaking research and exploiting arbitrage opportunities. New disclosure requirements could influence investment strategy, causing hedge funds to take holdings below the disclosable thresholds in order that other investors do not observe and copy their investment decisions and strategies. This could reduce hedge fund activity and profitability. More importantly this could reduce the incentives of market participants such as hedge funds to undertake research and arbitrage activities. In turn this could have a negative impact on market efficiency. This is because the research and arbitrage activities of hedge funds generally improve market efficiency.

40. An alternative negative consequence of requiring hedge funds to disclose their derivative positions would be to create an incentive for hedge funds to move their activities outside of the UK, either because they think this might exempt them from complying, or because they wish to move their focus away from the UK market to what they perceive to be a less regulated market.

Costs for CfD writers

41. The requirement to make disclosures may alter the way CfDs are used. E.g. CfD holders may choose to enter only into CfDs below the disclosure threshold. Thus there could be a drop in the number of CfDs being written, especially the larger CfDs. This could reduce income for the banks that write CfDs.

Costs to issuers

42. A drop in demand for CfDs may reduce demand for the underlying shares. This could in theory reduce liquidity in the underlying share and therefore increase the cost of capital. However the limited information we have from other jurisdictions does not suggest that disclosure of CfDs would have a negative effect on market growth or liquidity.

Costs to market participants

43. Market participants could face increased cost of monitoring a higher number of disclosures for meaningful information. This could require systems upgrades, or increased analysis time, or reduce the quality of the analysis as it had to take account of more disclosures carrying different informational value. Moreover, academic literature shows that excessive information can reduce liquidity. However, by setting the disclosure threshold at 5%, we would expect this impact to be manageable.

Benefits

44. In general Option 3 would target the same problems in the market (described in some detail in the body of this paper) as Option 2. Our starting point, therefore, is that the benefits of Option 2 and Option 3 are similar. However, there is one reason why the benefits of Option 3 may be lower than those of Option 2 and one reason why the benefits may be higher.

45. The benefits of Option 3 may be lower than those of Option 2 because in contrast to Option 2 there will be no indication whether the CfD holder has access to voting rights or only has an economic interest. As pointed out in our review of the academic literature, the potential value of increased CfD disclosure is linked to information about access to voting rights. This is also true for issuers, which are predominantly interested in CfD holders with access to voting rights. Under the disclosure regime of Option 3 it is difficult to disentangle which disclosures provide information about voting rights and which do not.

46. A possible benefit of Option 3 relative to Option 2 is that full disclosure of economic interests may give more certainty to CfD holders about their responsibilities under the disclosure regime. Once in place this might be easier for market participants to understand and comply with than Option 2, where disclosure is dependent on the particular legal structure of specific contracts, and the intention of parties involved. This could contribute to a high level of compliance. However, it is not possible to conclude that compliance with Option 3 will be higher than compliance with Option 2 because Option 3 will require more compliance activity from firms than Option 2 overall.

Literature Review: Effects of Major Shareholding Disclosures

Introduction

One of the underlying rationales for the dissemination of information about the identity of major shareholders[9] in companies admitted to trading on a regulated market is the theory that such information should help protect minority shareholders, help make markets operate more efficiently and thus improve market confidence.

Although very little economic literature directly addresses the issue of MSN, there is a vast body that examines the role of information in markets. That literature explores the possible impact of information and disclosure on (a) price efficiency of securities markets, (b) takeovers and (c) investor protection and corporate governance.

I Price Efficiency of Securities Markets

A transparent market is one which allows market participants to observe order flow and the trading process (see, for example, O'Hara, 1995). The academic literature in the field of market microstructure[10] highlights the importance of transparency in general for improving the process of price discovery and hence leading to more informative prices.

(i) Mechanics of information disclosure and value of disclosure

We set out below the key arguments in the academic literature that support mandatory disclosure. Most of this academic literature does not directly address the issue of MSN, but more broadly examines the value of disclosure in securities trading. Accordingly, in this section "information" means information related to past trades with buyer and seller identification.

Without regulation, the extent to which any valuable information becomes available to all participants depends on the costs of acquiring, processing and verifying such information as well as the attendant benefits that users/suppliers of such information derive. If these costs are low, relative to a given level of benefits, it is more likely that this information will be widely distributed amongst market participants.

9 These are referred to as Major Shareholding Notifications (MSN).

10 Market microstructure refers to the manner in which securities are traded and the impact on the behaviour of traders, volumes and prices.

– Mandatory disclosure of information eliminates the duplication of costs of individual acquisition of information. Accordingly, there is an argument that originators of information should be required to distribute the information (Gilson and Kraakman, 1984).

– Individuals may be unable to acquire valuable information because it is held only by informed traders. Because such undisclosed information is not incorporated into prices an adverse selection may be created in the market, i.e., only those traders with undisclosed information ("informed traders") will trade, while uninformed traders will prefer to wait for a public announcement or for more information from the market. Ultimately, any benefits of a reduction in information asymmetry derived from public announcements will depend on the speed with which the undisclosed information of the informed traders is incorporated into prices. There are two competing theories here:

  o Information is only partially revealed over time (Kyle, 1985): In a market with a single informed trader, the trader trades (a public event) in a gradual manner so that the information on which his trades are based is incorporated very slowly into prices. As a result, the depth of the market remains relatively constant over time. The implication is that the market does not incorporate the private information into prices, staying away from the efficient equilibrium.[11] Accordingly, there is some merit to the argument for mandatory public disclosure as it would benefit price efficiency.

  o Information is fully revealed: The second theory is that undisclosed information is fully revealed and, incorporated into prices as a result of aggressive trading (Holden and Subrahamanyan, 1992).[12] This theory only holds if all the traders have similar information. For example, if all traders believe that a security is undervalued due to some undisclosed information, they may all trade aggressively and this trading will then be reflected in prices for the security. In other words how quickly prices adjust to this information will depend on the volume of trades.[13] However, in a real-world scenario, where even informed traders may hold diverse information, there can in fact be poor informativeness of prices when multiple traders are present (Admati and Pfleiderer, 1988). This more realistic situation, as a result, would be supportive of public disclosure of information on trades.

– In some cases mandatory disclosures may not result in a price response unless the information is very costly or wholly unavailable to the market. This is not because the disclosure is irrelevant (or the information is of no value), but instead its direct impact may be on reducing the cost of acquiring and verifying information.

11 See Kyle 1985

12 Holden and Subrahamanyan (1992) consider the case where multiple informed traders exist in the market. They show that aggressive competition between traders causes all the private information to be incorporated into prices immediately, leading to a strongly efficient market.

13 Therefore, frequently, informed traders in an effort to avoid dissipation of their private information will trade at lower levels without altering market depth as suggested by Kyle (1985).

– There may be costs of disclosure as too much information can reduce liquidity, because traders are unwilling to reveal their intentions to trade.

The above analysis of the wider benefits of information about past trades and buyer and seller identification suggests that there can be benefits from disclosure in relation to price efficiency. These conclusions are also supported by empirical analyses that study abnormal price movements at the time of public announcements of insider trades (see, for example, Korczak and Lasfer, 2005).

(ii) Relevance for Major Shareholding Notifications

While there is no theoretical analysis of the value of MSN, an empirical study by Mikkelson and Ruback (1985) supports the idea that MSN announcements have an impact on prices. The authors examine Schedule 13D filings from 1978-1980. Schedule 13D (which is an SEC requirement similar to the DTR 5 requirement) requires disclosure of ownership of more than 5% in a class of securities to be reported within 10 days of purchase of the shares. Initial announcements that are not part of a takeover are associated with a statistically significant, positive, price increase for both the issuer and filing firms. This result also extends to firms that are taken over.

This empirical analysis would suggest that MSN may provide valuable (new) information. This information may be valuable because it could provide an indication of shareholder interests or which shareholders potentially have power (voting rights) to exert influence over the company. If this information is not completely incorporated into prices at the time of the trade, then mandatory disclosure would result in greater price informativeness.

However, there may also be costs of disclosure as too much information can reduce liquidity, because traders are unwilling to reveal their intentions to trade. Therefore, traders may for instance wish to reduce acquisition to just below the notification thresholds to avoid having to disclose their trading intentions to the market.

(iii) Other arguments for shareholder disclosure

Disclosure requirements are also associated with more developed stock markets. A cross-country study by La Porta, Lopez-de-Silanes and Shleifer (2006) examines the variation in stock market development in countries which have strong shareholder notification requirements relative to countries which do not. The key finding is that disclosure requirements, including disclosure of information regarding shareholders and inside ownership are positively related to measures such as number of listed firms, Initial Public Offering to GDP ratio and market capitalisation to GDP ratio.

(iv) Summary and implications

- The benefits of any disclosure depend on the extent to which undisclosed information does not already become incorporated into prices. Aggressive trading on undisclosed information should mean that the information becomes reflected into prices, i.e. prices are efficient.
- Empirical studies indicate that disclosures of insider holdings (e.g. directors' holdings) and MSN do have price impacts. This implies that prices do not adjust

fully as a result of the actual transaction, and disclosure has some role to play in revealing information that (uninformed) traders value. Moreover, while prices may account for the extent of the trading in a particular company, it is unclear whether important information about the identity of the trader (unless voluntarily disclosed) would become incorporated into prices. This information could also be valuable as different types of traders may have different investment strategies.

- One caveat remains. While information that reflects the motivations of traders can have a significant effect on asset prices (Forster and George, 1992), it can also be misleading – as shown in a theoretical model by Fishman and Hagerty (1992). For example, looking at disclosure of insider trades, the authors highlight that since only insiders know whether their trades are information – or liquidity motivated, disclosure can mislead other traders and can allow insiders to manipulate prices to their advantage. Therefore, the extent to which disclosure leads to a more informationally efficient market depends on the degree to which this disclosure can (or cannot) mask the trading intentions of the market participants.
- Too much information can also reduce liquidity, because traders are unwilling to reveal their intentions to trade. This is a cost of disclosure.

II Takeovers

The analysis of MSN in the context of takeovers presents some of the strongest arguments for the costs and benefits of disclosure. It is natural that large acquisitions of shares in a company can serve as a prelude to a takeover. Therefore, disclosure can serve as an important means of identifying takeover targets.

(i) Inefficient disclosure

It is suggested that regulation involving shareholder notifications can result in an inefficient transfer of wealth from informed bidding shareholders to other shareholders of target firms. This is because the strategic information of bidders will be revealed to other shareholders, creating a transfer of wealth from the former to the latter.

For there to be an active market for takeovers there should be sufficient incentives for the acquirer to put in an offer for the company and to recover his research costs in the form of an appreciation of the acquired equity investment, after gaining control. If there are constraints that prevent acquirers from profiting, there will be a disincentive for investors to engage in takeovers (Fischel, 1978). On the basis of this, it is argued that making private information public knowledge (through regulation) can actually *create* a regulatory failure i.e. by resulting in investors becoming more unwilling to engage in the market.

A study of MSN in Australia finds that these announcements do provide information to the market and result in an upward revision in share price that takes into account the probability of a synergistic takeover bid in the company (Bishop, 1991). The authors believe that this revision is related to the threat of a takeover and is not a permanent revaluation of the target that would result if substantial shareholders improved monitoring of management, and thus enhanced a company's long term value. This increase in the share price means that the cost of subsequent acquisition of shares increases, which reduces the gains that the bidder anticipates after the change in ownership of shares (Bishop, 1991). This represents a cost of a disclosure requirement and can possibly reduce takeover activity.

Pagano, Panunzi and Zingales (1998) similarly argue that there exists a trade-off between protection of minority shareholders and having an effective market for takeovers. Disclosures of shareholdings mean that potential acquirers are unable to gain a sufficient 'toehold' prior to the bid. Having to disclose the shareholdings much before the actual bid, means that the toehold and the profit for the bidder will be smaller (Ferrarini, 2002).

(ii) Disclosure encourages competitive bidding

Having a pre-bid ownership stake or toehold could be an effective strategy for a shareholder who would like to acquire the company. In this case, the acquirer has an incentive to bid even more aggressively because the bidding price is not only a price for the rest of the shares, but also an offer price for the toehold (Bulow, Huang and Klemperer, 1999). However, toeholds also discourage potential bidders from contesting the takeover, as they are at a competitive disadvantage relative to a bidder which already has a toehold. This is because the bidder has more of an incentive to stay in the bidding longer than if the bidder did not have any ownership stake (Bulow, Huang and Klemperer, 1999). Betton and Eckbo (1998) carry out an analysis of 1353 tender offer contests in the United States between 1971 and 1990. They find that the presence of a toehold increases the likelihood of having a single bidder, with bidders without a toehold being unlikely to revise their bid after an initial round. Therefore, theoretically speaking one would expect that disclosure, by discouraging toeholds, would not necessarily reduce corporate contestability and could, in fact, improve it. There is little empirical literature that directly tests this hypothesis.

However, there is a counter-argument here. With the exception of the study cited above, most empirical studies have contradictory findings: that in most takeover contests only a small proportion of the acquirers purchased a toehold prior to the bid (see for example, Bris, 2001; Bradley, Desai and Kim, 1988 and Jarrell and Poulsen, 1989). This finding would then suggest that potential bidders should not be discouraged from contesting a takeover and therefore the benefits of shareholder notifications, of discouraging toeholds, are limited. Most of these studies obviously examine direct equity interest. If for instance CfDs are commonly used to gain a toehold, which would not typically be accounted for in these studies, then the benefits of disclosure in this instance may remain. This issue is reviewed later.

Overall we believe that theoretically speaking, by minimising toeholds and providing information on impending takeovers, shareholding disclosures should improve the contestability of the market for takeovers. Thus, shareholding disclosures are an important tool for corporate governance (and market discipline) which benefits minority shareholders, who are less able to otherwise monitor managers (discussed in greater detail in the following section). However, they may also reduce probabilities of a takeover in itself by raising the costs of acquisition.

III Corporate Governance / Investor Protection

The final area in which one would expect some impact of MSN would be in promoting good corporate governance. While major shareholding notifications may not be as relevant in the context (see Berle and Means (1932)) of the widely-held listed firm, the more recent picture suggests that firms are not necessarily widely-held. Firms can have large shareholders acquiring more than 3-5% stake in the firm. Lack of knowledge of the identity of these owners creates an information asymmetry between these insiders and minority shareholders, and a lack of transparency on who holds the significant voting rights. Minority shareholders with lesser information than the 'insiders' and large block-holders, may be able to form their own coalitions especially at times of key voting and to monitor large shareholders.

Poor disclosure can worsen the information asymmetry between large shareholders and minority shareholders. The exacerbation of these information asymmetries means that minority shareholders remain uninformed and unable to react to information on ownership of the company. They may for instance wish to sell stakes in a firm upon knowledge of large stake-building by insiders, but without this knowledge will be unable to act on this information. This effect has been shown in recent empirical work.

Empirical literature shows that the shareholder incentives are proxied by both size and type of large shareholders, both of which have significant impacts on equity prices (see for example Hotchkiss and Strickland, 2003, Lins, 2003). While most studies do not directly examine the relationship between shareholding disclosure and the reaction of equity markets, they do find that the form of ownership structure of a listed company does lead to reactions in a firm's equity prices as a result of the implications it holds for the governance of the firm.[14] If there is no disclosure on identity of the major shareholders, the large shareholder can not only trade on his insider information, but can also gain private benefits of control through voting rights. A recent study on Canadian firms indicates that information on the identities of significant owners has an impact on bid-ask spreads of the firm (Attig, Gadhoum and Lang, 2005). The authors find family ownership is associated with an increase in bid-ask spreads which reflects the higher information asymmetry associated with their transactions.

Lack of transparency on ultimate owners (as is the case in emerging economies where cross-holdings and pyramid schemes allow owners to have ultimate economic interest that is more than their cash-flow rights) encourages owners to extract private benefits at the expense of minority shareholders (see for example, Claessen, Djankov, Fan and Lang, 2002). This void has been found to be associated with value-discounts (Claessen, Djankov, Fan and Lang, 2002). There is some support, therefore, for the idea that shareholding disclosures provide effective corporate governance and minority shareholder protection. Bishop (1991) however, argues that while substantial shareholder notifications may be important in identifying the potential for monitors of a firm, their main role is in providing the market information on the probability of an impending takeover, as we discussed earlier.

14 Alternatively, acquisition of large stakes can imply that these large shareholders can serve as external monitors for management and disclosure of this information may be viewed positively from a corporate governance perspective.

Voting rights have value because if a holder has significant votes, they may be able to have a significant role in making key decisions for the firm. Knowledge of vote buying by an insider can provide indications of whether the insiders are entrenching themselves further. Alternatively, control by outsiders may have positive repercussions for the firm in that they may positively influence governance especially if the firm is underperforming. Studies have provided evidence for these theoretical conjectures. In the US, studies have found that the average value of control can be around 2-4% of firm value (see for example, Zingales, 1995; Nenova, 2003), consistent with the idea that there is a market price for votes. Therefore, given that control is valuable, major shareholding notifications can be informative to the market and, in particular, minority shareholders, allowing them to take an informed view on the market for that company's shares. These notifications, then, reduce the risk of shareholder detriment.

The discussion above identified a possibility that greater shareholding disclosures could in fact reduce the probabilities of takeovers by making it costly for acquirers. This suggests a possible trade-off between good investor protection and having a market for corporate control. In some cases this trade-off does not really exist. In firms with large block-holders and controlling coalitions, there may be greater benefits from having a market for corporate control, in most other cases though, the benefits from greater investor protection through transparency may exceed any reduction in contestability of corporate control. In essence as argued by Ferrarini (2002) there is a distributional transfer as a result of disclosure requiring the regulator to place judgement on whether minority shareholder protection or having a market for corporate control has a greater weight in his welfare maximisation function.

IV Relevance for CfDs

A CfD exposes the CfD holder to movements in prices of shares without the holder typically having to buy or sell the physical. The CfD allows exposure to the underlying for a fraction of the cost of buying the assets. In this section we consider whether any of the arguments above would also hold for CfDs.

(i) Price Efficiency

From the perspective of price efficiency, there may be a natural extension for the disclosure of information on identity of CfD holders in improving the informativeness of prices of the securities. This argument, however, only holds to the extent that CfDs are often closed out with the underlying share (or CfD issuers vote on the instructions of the CfD holders) and that knowledge of the identity of major CfD holders has similar implications as the identity of a major shareholder. CfDs can also be a route through which informed traders can undertake strategic trading to prevent the release of information that would otherwise be revealed through MSN. If, however, informed traders (of equities and CfDs) have similar beliefs, then aggressive trading will automatically reveal information into prices, minimising the significance of mandatory disclosure.

If there is little voting on behalf of CfD holders, then benefits of mandatory disclosure of the identity of the CfD holder from the perspective of market efficiency are limited. It may be argued that, even if CfDs are only used to provide exposure to a sector or stock, knowledge of major CfD stake-building may still serve to provide important information to the market on trading interest. But the case for this is certainly weak.

Similarly though, there is always a risk of too much transparency in the market as discussed above. While leverage and ability to go short/long are the most important reasons for entering into CfDs (based on the PwC survey), stake building without disclosure was also cited as a reason for entering into CfDs. Therefore, given that the anonymity afforded by CfDs is not the most significant reason for entering into CfDs, disclosure may cause only small market liquidity declines in this respect. Moreover, there has not been a reduction in CfD usage or change in liquidity as a result of the Takeover Panel regime either. Of course other indirect effects of transparency such as costs of compliance could have stronger liquidity effects on the market. We do not explore these here.

(ii) Market for corporate control

Given the significance of MSN in providing the market information on possible takeover targets, one should expect the same argument to be significant in the case of CfDs. It is argued that CfDs can also be used as a tool to build stakes in quoted companies, avoiding the need for making the disclosures that are necessary when shares are purchased. The lack of notification allows stake-builders to gain sufficient toehold in the firm which can be converted into direct equity interest when they acquire the physical from the CfD issuer who is holding these shares as a hedge. As discussed earlier then, by providing notifications on CfD stake-builders, it can help to make takeovers more competitive which should benefit shareholders.

Does disclosure prior to bid-period provide value to the market?

What is the value of *additional* disclosure given that the Takeover Panel regime already requires trading in major CfD positions to be disclosed during the bid-period, which should help to make takeover contests more competitive? One method to identify takeover targets is through monitoring of trading in shares of the relevant company. Share trading in a firm should increase as potential bidders try to accumulate shares, either directly by buying shares outright or indirectly through CfD positions. In this case, without disclosure there will be information asymmetries in the market.

However, the economic benefits from disclosure will only emerge if most acquirers have a sufficient toehold in the company before launching a takeover bid. This would be contrary to most of the research we reviewed in earlier sections which did not find a large number of toehold cases in firms that were taken over. Moreover, full disclosure to the market may reduce the appetite for takeover as it reduces the gains to the bidder.

(iii) Corporate Governance / Investor Protection

CfDs *(if we assume that CfD issuers are willing to vote on behalf of CfD holders)* are in essence a form of 'hidden ownership', a term coined by Hu and Black (2007). This may be viewed both positively and negatively. On the positive side, hidden ownership can be a tool for hedge funds to have an influence on the governance of firms that are underperforming. Literature finds that monitoring by institutional shareholders can improve firm performance (see for example, Black, 1992; Monks and Minnow, 2004), although the same benefits should remain if the monitoring is carried out by a disclosed large owner (hedge fund).

On the negative side, CfD holders may use their votes (to the extent they can access the voting rights through the CfD issuer holding the underlying equity as a hedge) for objectives that are not necessarily aligned with those of the minority shareholders. This problem is exacerbated if there are undisclosed voting rights (Hu and Black, 2007). If these are disclosed, investors will accordingly adjust the price they wish to pay for the shares to account for this effect. However, if hidden votes are undisclosed and possibly change over time, investors may expect an adverse selection effect and discount (or alter) the price they pay for all shares (Hu and Black, 2007).

If eventually the shares fall into the hands of the CfD holder when the contract is closed out, the holding in the company must be disclosed under MSN rules and thus adverse selection and information asymmetry are reduced. Therefore, information asymmetry problems are highest during the period when the CfD is held – but only if banks vote on the instructions of the CfD holder. Therefore, in order for CfD disclosure to be beneficial in economic terms, there must be a strong link with voting. There is incomplete evidence on this and information on whether most CfDs are purchased prior to important votes, and the length of period for which CfDs are held can provide some indication of the extent of these problems.[15]

15 Survey results discussed elsewhere in the CP suggest that CFD holders do not, in general, gain access to voting rights through the CFD issuer.

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Determining the effects of Major Shareholdings Notifications

1. Summary

In order to better understand the information content of Major Shareholdings Notifications (MSNs) we examined the impact on share prices of a sample of MSN announcements in the period January 2006-August 2006.

The results suggest that MSNs are of some value to the market and contain information that investors use in pricing issuers' shares. The findings also indicate that market responses are asymmetric in most cases, with sales inducing statistically significant price falls while purchases show insignificant price rises. Announcements by other potentially passive investors like asset managers may also have significant market impacts but this is not conclusively established.

When we try and separate the effects of the transaction itself and the subsequent announcement, we find significant price movements around the time the actual transaction takes place. However, disclosure also has some further impact on price, suggesting disclosures contain some valuable information. The results should be interpreted carefully in light of our study's limited timeframe and sample size. Further work using more sophisticated methodologies must be undertaken to deal with some of these caveats.

While the results generally demonstrate that MSNs have some information value, it is difficult to link this conclusion directly to the case for CFD disclosures. MSNs may convey valuable information about ownership, voting structure and trading interest in an issuer. For this also to be the case for CFDs, the link with the right or ability to acquire shares or influence voting rights would need to be made.

2. Background

Under the UK's implementation of the Transparency Directive (TD) any shareholder (or those with rights to acquire shares) of an issuer traded on a regulated or exchange-regulated market (such as AIM and Plus Markets) is required to simultaneously inform the issuer and the FSA of changes to major holdings in that issuer's shares. MSNs are required when the shareholder reaches, exceeds or falls below specified thresholds. The key notification threshold is 3%, below which

MSNs are not required. Above 3% a shareholder must make disclosures at every 1% threshold that is breached. For example, in case of share purchases, a shareholder must disclose to the issuer and FSA upon crossing 3%, 4%, 5% and so on. The same requirements hold when stocks are sold and the shareholdings falls below specified thresholds as a result.

The process for MSN announcements is that shareholders are required to notify the issuer within 3 days (4 days if it is a non-UK shareholder) whenever they breach the specified thresholds. The issuer in turn has 1 day (2 days if it is a non-UK issuer) to announce this information to market.

CP 06/04 on the implementation of the Transparency Directive argued that these disclosures ensure that investors and issuers can accurately determine the voting structure of an issuer's capital, enhancing transparency of ownership interests and potentially important capital movements.

This study seeks to examine the effect of the announcement of shareholdings to the market. A measure of price movements over the period where information from disclosure would be released known as the Cumulative Abnormal Return (CAR) is derived. This allows us to see how market prices react to information about large shareholders of the firm. We derive first a model of normal or 'expected' returns. The details of this model are in the Annex. The abnormal return on a given day is the difference between the expected return from our model and the actual return. By adding together abnormal returns over a specific time period (e.g. from 1 day before up to 1 day after disclosure) we calculate the CAR.

The underlying hypothesis is that if the market values MSN disclosures, then any such announcements should result in *statistically significant* price movements around the disclosure time. However, if these disclosures do not convey any important information to the market, then there should not be any (statistically significant) price movements at this time. Most of the price movements should instead be captured around the transaction date.

There may be other market impacts of MSNs which may not be picked up in our study. Therefore, a finding of insignificant price movements may not necessarily suggest that disclosure has no value. For example, one view is that shareholding disclosures should only confirm market expectations and hence do necessarily result in a movement in prices. Therefore, while they may still be of value, our methodology will not be able to pick up these effects as it relies on movements in prices.

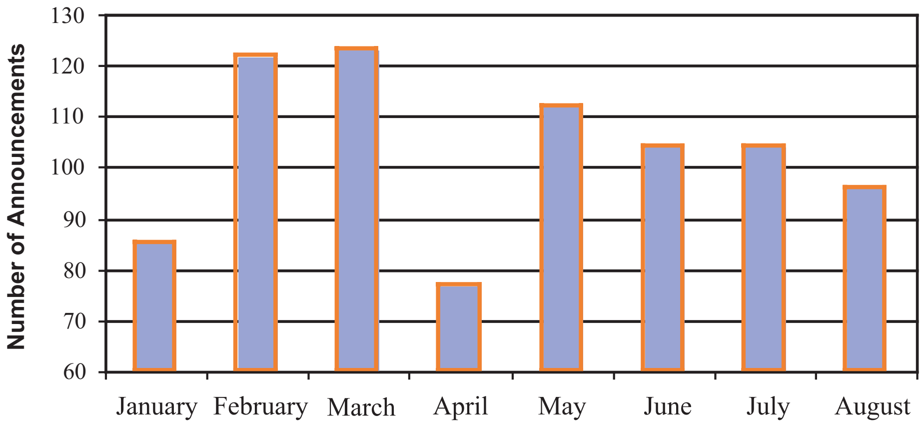
3. Data

We have collected data on all announcements related to MSNs (i.e. changes in shareholdings that crossed the disclosure thresholds). Our initial sample included 2773 announcements for the eight month period from 1 January to 30 August 2006. This period was the latest period for which data was available at the time of initiation of the study.

Data Filtering

We employed a number of filters in arriving at our final sample of announcements. First, we dropped announcements relating to issuers for whom we could not find stock prices in Bloomberg (presumably due to a takeover or no trading activity). Second, in cases where multiple announcements are made by a shareholder in an issuer on the same day, we only took the last announcement into consideration. Avoiding this double counting of multiple announcements, we were left with 2267 disclosures.

Figure 1: Number of Announcements by Month (2006)



A significant proportion of the data does not include information on whether the announcement is a result of a sale or purchase. An example of announcements which do not carry this information is as follows: "On 9 September 2006, we have received notification that firm X and its subsidiaries are interested in 3.8% of ordinary shares of company Z". Therefore, without making ad-hoc assumptions, it is difficult to glean from such announcements whether the resultant 3.8% is because the firm has disposed of shares or acquired more shares. Given the possibly diametrically opposite effects of a sale relative to a purchase, taking all these announcements together could confound the results. Therefore, we separately examined announcements that could be clearly linked to a purchase or sale and analysed these as separate and distinct events. There are 829 announcements which allow us to separate buys and sells. Figure 1 shows the monthly breakdown for our sample of MSN announcements.

Disclosure versus Transaction Times

Out of these 829 announcements, 473 included the date when the transaction actually took place. This information allows us to evaluate the length of time between the transaction and announcement dates. A large share of MSN announcements occur within 3 days of the transaction date, while the majority seem to occur within 5 days of that date. This is true for both purchases and sales. In a limited number of cases, this delay can be over 5 days; however, delays over 10 days are uncommon.

We document the difference between transaction date and disclosure date in Figures 2A and 2B for buys and sells, respectively. The figures suggest that disclosures for buys happen slightly sooner than that for sales: buy disclosures happen on average 2.8 days after the actual transaction, while sales disclosures occur on average 4.3 days subsequent to the trade.

Figure 2 A (Buys: Date of Disclosure – Date of Transaction)

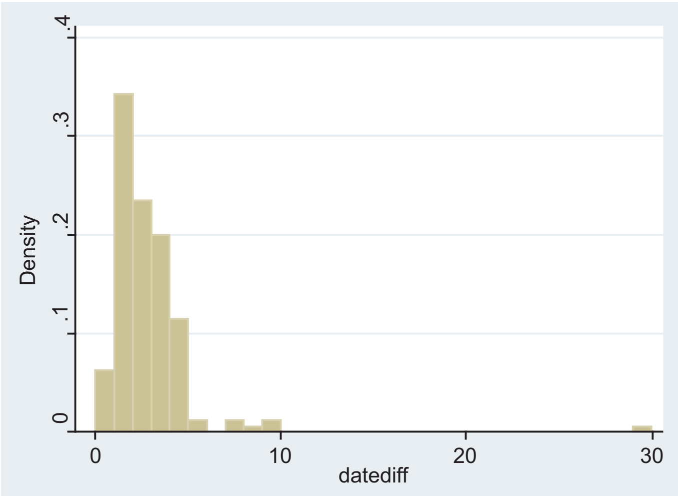
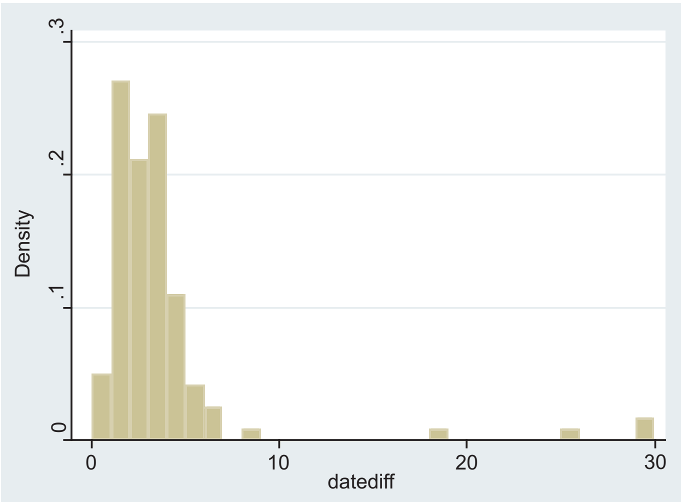


Figure 2 B (Sells: Date of Disclosure – Date of Transaction)

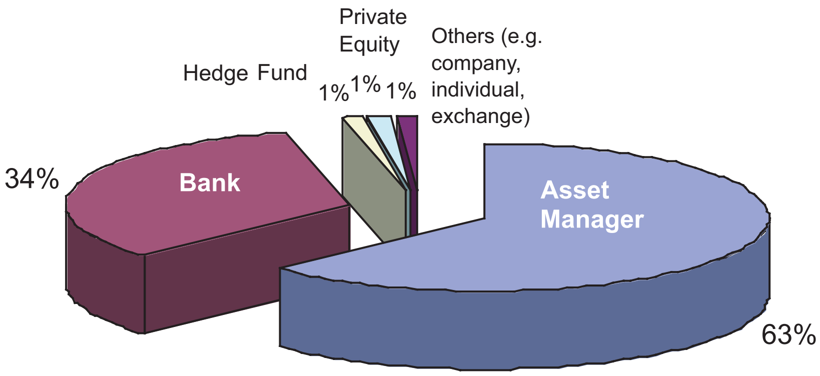


This gap in transaction and disclosure date are on average within the MSN requirements. The requirements give a limit of 3 days for the shareholder to disclosure to the issuer (or 4 days in case of non-UK shareholder). The issuer has a further day (or 2 days in case of non-UK issuer) to disclose this to the market. So a total of 4-6 days difference between transaction and announcement date is not uncommon. Most of our data points lie within this band, and in many cases the announcement to the market is much faster. The few outliers could either be the result of incorrect coding of transaction date or they could be cases of non-compliance.

Shareholder Type

Our announcement data contain information on shareholder type, which facilitates analysis of market responses based on key shareholder classifications: investment banks, asset managers and alternative investors (includes hedge funds and private equity firms). Not surprisingly, investment banks and asset management companies make up the majority of announcements (see figure 3).

Figure 3: Breakdown of announcements by shareholder type



We also have information on total shareholding at the time of announcement and cases where the shareholder falls below the 3% threshold and therefore no longer has a significant stake in the issuer. This information may prove useful in evaluating the marginal information content of MSNs at different ownership thresholds.[16] In some cases the announcements also contain information on the size of the trade, allowing us to separate block trades from non-block trades. We looked specifically at trades where more than 0.5% of the company's shares were either bought or sold in a single transaction.

Sample Biases

We should mention here possible sample biases. While we look at the entire sample in the first instance, we are unable to breakdown the entire sample into buy and sells as not all announcements carried this information. We noticed that particular announcers report in a certain format and do not reveal the buy and sell. So potentially the sample is biased, as in almost all cases it does not include separate announcements by these particular issuers into buys and sells. As discussed earlier, some of these announcements get filtered out, which poses the possibility of sample bias. There are two further possible biases when we look at transaction dates. Firstly, as above, not all announcements data contained transaction dates. Again these were announcements by specific shareholders, which could result in selection bias. Secondly, in many cases the transaction date is not clear from the announcements. Sometimes it is very clearly delineated as the date of transaction, in other cases the announcement states: "We have received a letter dated 20 March 2007 from shareholder X…" or in other cases it will state "As of 20 March 2007, shareholder X has 10% shareholding…" While in

16 While we did not undertake a thorough analysis of this type as part of our work, we did look at whether and how the market reacted to announcements at the 3% and 5% thresholds. The results are discussed later.

the latter case, it may be more clear that 20 March is the transaction date in the former it is less clear and so we are also forced to exclude the former announcements. These biases should be kept in mind when interpreting the results.

4. Methodology

Event Study

We tested the hypothesis that MSNs are used by investors, using standard event study methodology. Very simply, this approach allows us to measure abnormal price effects both on the trading date and the disclosure date for purchases and sales and to evaluate whether these abnormalities are statistically significant. Finding statistically significant price effects on either or both of these dates would provide evidence that trade information and/or MSNs are of value to the market. The concepts behind such an event study are set out in detail in FSA's research papers on market cleanliness.[17]

We followed an accepted calculation methodology (described in detail in the Annex) to examine abnormal price movements around the announcement date. This methodology is similar to that followed on FSA's research papers on market cleanliness. The methodology allows us to isolate the effects of announcements from normal market or sector movements. It allows us to see the 'abnormal' price movements compared to normal or expected returns.

To identify whether stock returns are abnormal, we used a statistical (market) model of normal or 'expected' returns. The abnormal returns on any day are the difference between expected returns from this model and the actual return. By adding together abnormal returns over time, we calculate the CARs.

To provide some sense for how to interpret CARs, let's take the example of an MSN announcement made by an issuer to the market that a private equity firm has taken control of 10% of its shares. One interpretation is that if this announcement is considered good news (and only becomes known to the market at that time) about the potential future performance of the firm, the stock price will most likely increase, everything else being equal. This gives rise to a positive post-announcement CAR.

5. Results

The results are reported for two different techniques. Before discussing these results we describe each of these techniques.

Firstly, we estimated a regression model[18] to understand the key factors that drive these price movements (CARs) that we have computed i.e. is it the shareholder type

17 See Occasional Paper 23, Measuring market cleanliness, FSA, http://www.fsa.gov.uk/pubs/occpapers/op23.pdf and Occasional Paper 25, Updated measurement of market cleanliness, FSA, http://www.fsa.gov.uk/pubs/occpapers/op25.pdf

18 An ordinary least squares (OLS) procedure is used to estimate an equation of the form:

$$CARs = \alpha + \beta_1 Assetmgr + \beta_2 Bank + \beta_3 Initialtrade + \beta_4 Sizeoftrade + \varepsilon \ .$$

where Assetmgr is a dummy where the announcement was made by an asset management firm; Bank is a dummy where the announcement was made by a bank; Initial trade is a dummy for the first announcement by a shareholder in the firm; Size of trade is a continuous variable that measures the size of the trade that resulted in the disclosure. Specifications involving additional variables such as total holdings after the announcement and the first or last time an announcement in made in a particular issuer were also tested. These were insignificant and are therefore, not reported in the final specification. The results were broadly robust to their inclusion and exclusion.

or the size of the trade that significantly affects the abnormal price movements. It also helps to explain the marginal or incremental effects of these other factors in explaining CARs. This helps us control for all other factors that may be affecting CARs. The regression analysis is reported only around the -2,+2 window (2 days before and 2 days after the announcement), although the results do not change for the -1,+1 window.

As a second robustness check, CARs are also compared across different cuts of the sample. Once we have obtained CARs for each disclosure, not only do we summarise the average CAR for the entire sample, we also use different cuts of the sample which are described below:

1 For the entire sample (All); only those announcements which were the first time a particular shareholder had acquired stake in the firm (Initial Trade) – we used this because it was possible that the market may only move then and not at subsequent times; only those announcements where there was an announcement in a particular issuer for the first time (First Firm) and finally those announcements where there was an announcement in an issuer for the final time in our dataset (Last Firm).

2 For unique trade types such as block trades;

3 For transactions by unique shareholder types (Alternative investors including hedge funds and private equity; Bank and Asset Manager);

4 For cases where the shareholder held less than 5% stake in the company. For sales transactions, we expanded the analysis and looked at the reactions in cases where the transaction resulted in shareholder ownership below the 3% threshold.

These are reported in Table 2 in the Annex.[19] The reason for reporting these sample splits in addition to the regression analysis is because the sample splits provide further information about the sample characteristics.

5.1 Does Disclosure Matter? (see Tables 1 & 2 in the Annex)

For disclosure to have value, the CARs we have calculated should be statistically significant. Both Tables 1 and 2 (see Annex) show the CARs to be statistically significant. The results in Table 1 show that there are price movements that are statistically different from zero, when announcements are made by particular shareholders; when the announcement relates to a trade that is 'initial' (see our definition of 'initial' above) or if a large block trade is carried out.

Table 2 also provides similar support to these conclusions. For overall trades, there are significant abnormal price movements (CARs) but these are mostly driven by the sell announcements which are also separately statistically significant. We find small price reactions in almost all cases for buy transactions.

The direction of abnormal price movements is in line with theoretical expectations. Large purchases that result in significant shareholdings may indicate positive information about the firm, resulting in positive price movements and similarly large sales should result in negative price movements.

19 The same sample cuts are also used in Tables 3-4.

The results were broadly robust across the two event windows (-2,+2 and -1,+1).

Therefore both results from two different methods reported in Tables 1 & 2 show that there are some significant abnormal price movements at the time of disclosure. It is possible though that some of the significant results for disclosure are in fact due to the market moving to the transaction which took place a few days ago rather than the actual disclosure. In the next section we try to determine the marginal impact of MSNs beyond the transaction effects.

5.2 Does disclosure have marginal value? (see Tables 3 & 4 in the Annex)

The analysis shows MSNs do result in significant price movements. However, given that the time period between the disclosure and transaction date is small, it is possible that the results are due to market movements around transaction dates.

For example, Korczak and Lasfer (2005)[20] find significant price movements on insider trades around transaction dates as well as disclosure times. Gemmill (1996)[21] in a study for the OFT found that disclosure of block transactions (or a delay in disclosure) did not have any significant price impacts. Instead, the market reacts at the time the block transaction takes place. One word of caution is that the latter study considers large block trades which are more likely to move the market as opposed to the announcements in our data – these may not necessarily have been a result of a single block trade.

To analyse this issue we look specifically at events in our sample where the event transaction and disclosure date are more than two days apart. In order to create completely non-overlapping periods around the transaction and disclosure dates we would need a gap of between 3-5 days between these dates (which can in fact exceed the regulatory requirements). The problem is that this gap reduces total events to a small number, which makes sense given that the maximum (prescribed) gap between announcements and disclosure is 4-6 days. We therefore only consider a 2 day separation for both event windows.

We have considerably fewer observations than those in Table 1 because we had very little data on the transaction date. Table 3 indicates that some CARs (related to asset managers) still remain statistically significant around disclosure time, although other significant effects have disappeared.

There are more statistically significant price movements around the transaction time (see Table 4).[22] However, the results seem to indicate that both disclosure and the transaction generate significant abnormal price movements. Not all disclosures generate abnormal price movements, because not necessarily all of them carry price sensitive information. One conjecture is that that the increased gap between trade and disclosure date that is used for this sample may be confounding the results. It is

20 Adriana Korczak and Amezaine Lasfer, 2005, Insider trading and international cross listing, working paper.

21 Gemmill, Gordon, 1996, Transparency and liquidity: A study of block trades on the London Stock Exchange under different publication rules, Journal of Finance 51, 1765-1790.

22 Separate analysis was also carried out for buys and sells. We find some significant abnormal returns in the case of sells. We did not find any significant abnormal returns around disclosure time for buys. This may be because of the reduced sample size. We therefore, report the results for the entire sample.

possible that full instantaneous disclosure may have more value than disclosure which happens a few days afterwards and our results could possibly be reflecting this. We tried to validate this conjecture by using regression analysis. However, our results are inconclusive.

6. Robustness checks and caveats

Several robustness checks such as through regression analysis have been carried out to conclusively establish these results. While, some of the robustness checks have yielded similar results, others will require further work.

For example, the analysis in Tables 3-4 indicates that disclosure continues to have value once the transaction effects have been considered. However, the regression exercise which controls for all other factors is not able to validate this. This does not necessarily indicate a rejection of earlier conclusions because choice of estimation procedure may be affecting the results.

The event window used to measure the effects of disclosure also includes 1 or 2 days before disclosure. It may be more appropriate to consider only the post-disclosure period, as we are assessing only the impacts of the actual announcement. While most academic papers do not follow this approach, as a robustness check we do consider this revised event window. Using this, we continue to find some cases where disclosure results in significant abnormal price movements. These are, however, fewer compared to the wider event window i.e. the main impact happens at the time of transaction and there is a smaller resultant impact at the time of disclosure.

This paper computes abnormal returns using an OLS estimated market model. However, it is possible that the assumptions required for this simple model may not hold in the underlying data.[23]

Finally, the limited time-frame of the study and small sample must be considered while interpreting the results.

7. Conclusion

We have looked at average CARs around announcements of MSNs and the actual transaction date. Key findings and their implications are as follows:

5 There are some significant price effects around the public disclosure date. While the results do not indicate all disclosures to be valuable, these findings would also be in line with other published academic literature (see for e.g. Korczak and Lasfer, 2005) which finds disclosure on shareholdings to convey information (see for e.g. Korczak and Lasfer, 2005; Mikkelson and Ruback, 1985).[24] Our finding of significant price movements continues to hold even after separating out possible impacts on prices as a result of the trade, although the main effect is at the time of the trade.

23 The variance of daily abnormal returns may change over returns (heteroscedasticity) and abnormal returns on nearby days may not be independent (serial correlation). To control for the first of these problems an Autoregressive Conditional Heteroscedasticity (ARCH) may be needed.

24 Mikkelson, Wayne H. and Richard S. Ruback, 1985, An empirical analysis of the interfirm equity investment process, Journal of Financial Economics 14, 523-553.

6 These results have been independently refereed by an academic. We are aware of more sophisticated regression methodologies that can be used to check robustness of the findings. Moreover, more complete reporting data on MSN will allow us to carry out more refined statistical analysis. This will help sharpen the estimates of the value of disclosure. However, the key message which we do not expect to change is that MSN announcements appear to contain some information which is used by the market in pricing securities.

7 While it is difficult to relate these results directly to CFDs, given that we find some types of disclosure have value, it is possible that CFD disclosure could also be of value to the market. However, as the disclosures we studied in this paper relate to shareholding stakes, the role of CFD disclosure could also depend on whether CFD holders also indirectly have access to voting rights.

Calculation Methodology

We follow MacKinlay (1997)[25] and calculate expected returns by estimating a statistical relationship between the stock and the market as in equation 1 below:

$$R_{it} = \alpha_i + \beta_i R_{Mt} + \varepsilon_{it} \qquad (1)$$

Where R_{it} is the actual return on the security for firm i at day t (computed using daily stock prices as $\ln(P_{i,t}/P_{i,t-1})$) and R_{Mt} is the daily return on the FTSE All Shares Index.

We estimated the parameters α_i and β_i in equation 1 using an OLS regression of the returns on a constant and returns on the market index. The model was estimated using daily data on stock returns and the FTSE all share index over 240 trading days ending 10 days before the announcement. The parameter β captures the extent to which the stock's return depends on the market return over that period, while α represents the expected value of the daily return to that stock in addition to any market-driven movements.

After estimating (1) using the 240-day period that excludes MSN announcements (i.e., a benign or normal period), we compute the abnormal price movements over an event window using equation 2, where AR_{it} is the abnormal returns for firm i at day t. and the expected return is represented the expression in (2) (estimated from (1)).

$$AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{Mt}) \qquad (2)$$

$$CAR_t(\tau_1, \tau_2) = \sum_{t=\tau_1}^{\tau_2} AR_{it} \qquad (3)$$

These abnormal returns in (2) are added up to generate cumulative abnormal returns (CARs) over an event window ($\tau1$, $\tau2$). This is set out in equation 3. The event window spans the period of time over which it is believed that information content could be released to the market and is the period over which CARs are calculated. It encompasses the event or events in question, which in our case includes shareholder trades and MSN disclosure dates. The selection of an appropriate event period is important and a decision which reflects a number of factors. The longer the window, the more difficult it is to detect statistically significant returns.

We used two event windows from day -2 ($\tau1$) to day +2 ($\tau2$) and day -1 ($\tau1$) to day +1 ($\tau2$) to compute the CARs, so as to determine whether the results are sensitive to choice of event window. 2 days before the announcement period are included as some information may leak out into the market just prior to official announcement. However, we deliberately keep the event window small to see the market reaction up to 2 days after the disclosure. The -1,+1 event window is also used in literature testing impacts of such disclosure. These choices are also consistent with the previous information regarding the timing of MSNs that showed that they typically

25 Mackinlay, A. Craig, 1997, Event studies in economics and finance, Journal of Economic Literature 35, 13-39.

occur within 3 days of the transaction date.) Moreover, it is recognised that new information is incorporated into stock prices relatively quickly and so a maximum of two-day post-event window should suffice.

To test whether these abnormal price movements are statistically significant and different from zero, we estimate the Z-statistic as follows[26]:

$$ASPE_t = \frac{1}{N}\sum_{i=1}^{N}\frac{AR_{it}}{S_{it}} \qquad (3)$$

$$Z - statistics = \frac{\sqrt{N}}{\sqrt{T_2 - T_1 + 1}}\sum_{t=T_1}^{T_2} ASPE \qquad (4)$$

Separate models are run around the transaction date and disclosure date. Finding that the abnormal price movements are statistically significantly different from zero around the disclosure date would provide evidence that MSNs are of value, consistent with the notion that investors use such information in pricing an issuers' securities. Similarly, finding statistically significant abnormal returns around the transaction date would suggest that the market finds information on the trade itself useful in pricing issuers' securities.

Table 1 – Regression on Cumulative Abnormal Returns (CARs)

The table below presents OLS regression results on cumulative abnormal returns [-2,+2] for entire sample, buys and sells. Absolute values of t-statistics are reported in brackets; ***, ** and * represent significance at the 1%, 5% and 10% levels.

	All	Buys	Sells
Asset Manager	-2.32	-3.43	-1.29
	[2.15]**	[2.28]**	[0.85]
Bank	-1.88	-3.46	-0.42
	[1.68]*	[2.24]**	[0.26]
Holdings <5%	-0.12	0.18	-0.45
	[0.30]	[0.29]	[0.89]
Initial trade	-0.17	1.39	-1.57
	[0.45]	[2.39]**	[3.25]***
Size of trade	0.05	0.03	-1.75
	[0.69]	[0.30]	[1.82]*
Constant	2.22	2.88	1.81
	[2.06]**	[1.92]*	[1.19]
Observations	458	212	244
R-squared	0.01	0.05	0.07

26 ASPE=Average standardised prediction errors, where Sit is the estimated standard deviation of the prediction error; ARit as defined in equation 2 is computed within the event period of -2, +2; N is number of securities (events); T1 is beginning of event window (-2) and T2 is end of the event window (+2). We follow Tehranian, Hassan, Travlos, Nikolaos and James Waegelein, 1987, The effect of long-term performance plans on corporate sell-off-induced abnormal returns, Journal of Finance 42, 933-942.

Table 2 – Cumulative Abnormal Returns (CARs) around disclosure:

The table below summarises CARs for announcements, using the date of disclosure as the event date and 2 days before and after the event being included in the event period. N refers to number of events, *CAR* refers to cumulative abnormal returns and *Z-stat* is the statistics that tests for the significance of CAR i.e. whether they are different from zero. ***,** & * refer to significance at the 1%, 5% and 10% levels. *Initial* refers to first announcement by a shareholder in a particular issuer; *first firm* refers to first announcement in a particular issuer in the sample; *last firm* refers to final announcement in a particular issuer in the sample; *block trade* refers to announcements in trades of larger than 0.5% of the company's shares; alternative investors refers to announcements by hedge-funds or private equity firms; *bank and asset manager* refer to purchases made by each of these investors, respectively; *sell <3%* are announcements where holdings of shareholders fell below the 3% threshold; *holdings<5%* refers to announcements where the shareholder had less than 5% stake in the firm;

	-2, +2 days Around Disclosure Date			-1, +1 Around Disclosure Date	
	N	CAR	Z-Stat	CAR	Z-Stat
Overall	2267	-0.21%	-1.82*	-0.11%	-1.17
Initial Trade	948	-0.32%	-2.49**	-0.23%	-2.50**
First Firm	205	-0.48%	-2.41**	-0.10%	-0.90
Last Firm	194	-0.27%	-0.68	-0.04%	-0.20
Trade Type					
Block Trade	131	0.09%	0.27	0.24%	0.75
Type of Shareholder					
Alternative Investors	53	0.27%	0.02	0.26%	0.39
Bank	998	-0.17%	-0.73	-0.05%	-0.15
Asset Manager	1128	-0.27%	-1.74*	-0.18%	-1.49
Other					
Holdings<5%	873	-0.18%	-1.16	-0.27%	-1.69*

Panel B

	BUYS				
	-2, +2 days Around Disclosure Date			-1, +1 Around Disclosure Date	
	N	CAR	Z-Stat	CAR	Z-Stat
Overall Buy	319	0.07%	0.61	0.05%	0.43
Initial Buy	145	0.59%	1.88*	0.29%	1.17
Trade Type					
Block Trade	120	0.30%	0.92	0.33%	1.16
Type of Shareholder					
Alternative Investors	14	1.76%	0.87	1.34%	1.11
Bank	88	0.18%	0.85	0.21%	0.7
Asset Manager	215	-0.10%	-0.08	-0.12%	-0.33
Other					
Holdings<5%	109	0.21%	0.7	0.18%	0.72

Panel C

	SELLS				
	-2, +2 days Around Disclosure Date			-1, +1 Around Disclosure Date	
	N	CAR	Z-Stat	CAR	Z-Stat
Overall Sell	510	-0.20%	-1.58	-0.24%	-2.24**
Initial Sell	227	-0.63%	-3.10***	-0.69%	-3.86***
Trade Type					
Block Trade	11	-2.20%	-2.12*	0.82%	-1.24
Type of Shareholder					
Alternative Investors	5	0.78%	0.21	0.07%	-0.13
Bank	188	0.18%	0.35	-0.13%	-0.37
Asset Manager	300	-0.39%	-1.88*	-0.22%	-1.74*
Other					
Sell < 3%	178	0.22%	-1.29	-0.19%	-1.13
Holdings<5%	281	-0.36%	-1.91*	-0.27%	-1.69*

Table 3 Cumulative Abnormal Returns (CARs) around disclosure (events non-overlapping with transaction)[27]

	-2, +2 days Around Disclosure Date			-1, +1 Around Disclosure Date	
	N	CAR	Z-Stat	CAR	Z-Stat
Overall Trade	436	-0.25%	-0.92	-0.13%	-0.61
Initial Trade	195	-0.20%	-0.97	-0.08%	-0.85
First Firm	61	-0.19%	-0.69	-0.06%	-0.75
Last Firm	59	-0.50%	-0.95	-0.20%	-0.37
Trade Type					
Block Trade	31	0.66%	1.01	0.49%	1.11
Type of Shareholder					
Alternative Investors	10	-0.37%	-0.06	-0.51%	-0.47
Bank	317	0.02%	0.57	0.04%	0.75
Asset Manager	105	-1.06%	-2.75***	-0.55%	-2.04**
Other					
Holdings<5%	198	-0.06%	0.10	-0.12%	-0.40

Table 4 Cumulative Abnormal Returns (CARs) around transaction (events non-overlapping with disclosure)[28]

	-2, +2 days Around Transaction Date			-1, +1 Around Transaction Date	
	N	CAR	Z-Stat	CAR	Z-Stat
Overall Trades	436	0.20%	1.55	0.36%	3.21***
Initial Trade	195	0.13%	0.64	0.21%	0.03
First Firm	61	1.03%	2.09**	0.95%	1.51
Last Firm	59	-0.33%	-0.56	-0.33%	-0.81
Trade Type					
Block Trade	31	0.55%	1.19	-0.04%	0.05
Type of Shareholder					
Alternative Investors	10	0.76%	0.55	-0.09%	-0.23
Bank	317	0.40%	2.38**	0.52%	3.83***
Asset Manager	105	-0.42%	-1.09	0.00%	0.27
Other					
Holdings<5%	198	0.12%	0.54	0.25%	1.46

27 Separate analysis for buys and sells was also carried out and is available on request.

28 Separate analysis for buys and sells was also carried out and is available on request.

Survey on Contracts for Difference by PricewaterhouseCoopers LLP for The Financial Services Authority

Contents

Executive summary

Key findings

We have found that the selected respondents were not in favour of a new regime being introduced specifically for Contracts for Differences (“CFDs”), and did not agree that it would improve transparency or bring any benefit to the market.

The majority of them also thought that, should such a regime be introduced, it would increase confusion in interpretation of market movements, would lead to double counting, would not solve the initial problem and would increase costs and complexity without clear benefits.

Most participants said that they do not necessarily hedge their CFD positions by buying the underlying shares, but here we found significant differences in practices depending on the size and type of organisation.

All participants categorically stated that they would not vote under the instructions of any client, but reserve the right for themselves to vote in instances where it is in their interest as a bank or a group.

At the same time, most of them declared that parties which are beneficiaries of an interest through a CFD occasionally seek to exert influence over voting rights in the physical holdings in the underlying held by the bank or firm.

All participants except one said they would not enter into pre-arrangements in relation to selling the underlying assets to the CFD holder at the closing of the position.

Most participants enter into CFDs with hedge funds and selected “Leverage” as the key reason for their clients entering into CFDs. Most participants use CFDs with 3-6 months maturity, contracts varied from 648-120,000 per month and monthly average volumes ranged from £150K - £3billion.

Purpose of survey

We have been engaged by the FSA to conduct focused market research on their behalf on CFDs to demonstrate to the market that proper analysis and consideration has been given to exploring the motivation behind CFD trading and its potential role in influencing voting rights, stake building and impact on price formation.

In addition our research was designed to explore how CFDs work in practice, what participants thought of the current regimes dedicated to market transparency and finally what the selected financial institutions thought of a disclosure regime for economic interest in shares to be introduced.

This survey is one of eight work streams dedicated by the FSA to explore the mechanism and impacts of CFDs on market transparency and its findings will feed into a wider Discussion Paper being prepared by the FSA.

Survey methodology

Questionnaire

There were 38 questions in the survey designed to gather data against the suggested areas highlighted by the FSA in its statement of requirements. The questions were divided into five sections: the Client base, CFD portfolio, Hedging policy, Voting policy and Views on the introduction of disclosure.

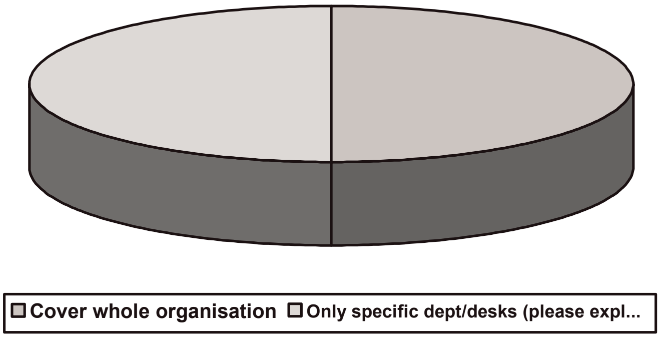
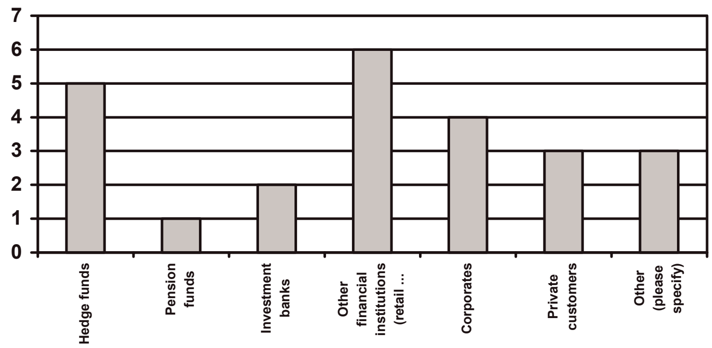
The interviews

Besides the factual data gathered, we conducted interviews with the market participants to obtain understanding of the different reasons for trading CFDs, of their CFD related processes in practice and to explore their views and opinions on the status of market transparency in terms of CFDs and possible changes to the disclosure regime. At these interviews in most cases the companies were represented by the heads of their compliance teams, disclosure teams and business heads from the Derivatives/ CFD desks. (Appendix 1)

Our analysis

Our analysis was focused on the responses received from the survey, picking up determining themes coming out of the interviews, in search for a majority market view.

Survey Results

Q1 The scope of questions apply to which part of the organisation?  6 answered Cover whole organisation 6 answered Only specific desk 1 answered N/A	Comment: Half of the participants answered that the questions apply to the whole organisation. Those who answered "specific desk" listed the following: • Equity Finance Desk • Synthetic Products Group, Global Banking business which includes M&A and Legal • Institutional equities business • Prime Services Swaps Desk • European Cash Trading Desk • European Equity Brokerage Division • CFD desk
Q2 What type of clients do you enter in to CFDs with? Number of votes  	Comment: Most participants enter into CFDs with hedge funds, other financial institutions and corporate. Under others we found: • 'Intermediate Customers including Expert Private Customers • 'stockbrokers, futures brokers, spread betters • Prime brokerage clients
Q3 Of those listed please rank the top three in order of the volume of transactions they generate?	The participants ranked hedge funds on the top, other financial institutions as second and investment banks as third.

Client base

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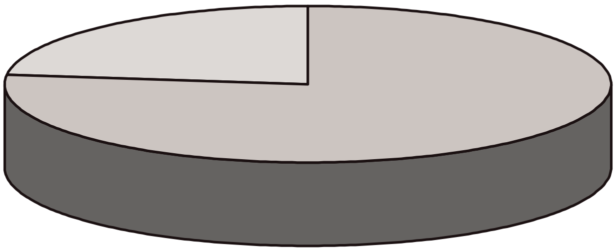
Q4 Do you offer CFDs to only certain clients?



10 answered Yes
3 answered No

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Comment:

77% said Yes

23% said No

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Q5 If yes, please explain in the box below:

- We do not deal with Private Customers. Clients are subject to appropriate credit checks and limits are placed on their activities.
- Only to Intermediate Customers and Market Counterparties.
- The institutional business does not offer CFDs to private clients.
- Depending on their sophistication and following suitability criteria set out in the Global Suitability Policy.
- We currently do not accept private clients. We only accept intermediate clients, private expert opt ups, or market counterparties.
- Only Professional clients.
- We only deal with institutional investors.
- They must have experience of very active share trading or contingent liability risk
- We enter in CFD contracts pursuant to the negotiation of both an ISDA agreement and a specific CFD agreement. In addition specific credit checks are undertaken and we will only enter into CFD contracts once the relevant documentation and the appropriate credit checks are in place.

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Comment:

Although “easy usage for clients” has been named as one of the key attributes of CFDs some level of sophistication is necessary.

Based on the interviews:

The smaller pure brokerage companies seem to have more private clients than the big sophisticated investment banks, whose clientele consists of mainly other big corporates.

Credit risk and size seem to be the driver behind the selection of clients. The smaller brokerage companies said they prefer many smaller (private) clients rather than fewer big ones, as they can only take limited credit risk in one transaction and with one client due to their own size.

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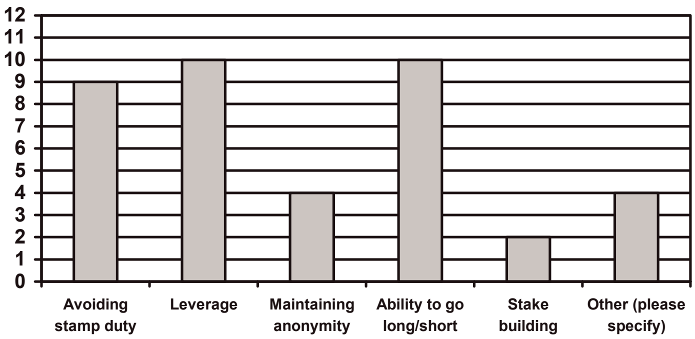
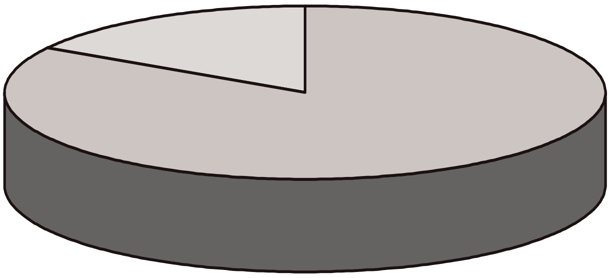
Client base

Q6 What reasons do your clients express for entering into a CFD rather than buying the underlying stock directly? (please select that all that apply) Number of votes 	Comment: Most participants selected Leverage as the reason for their clients entering into CFDs. Ability to go sort/long came second and avoiding stamp duty came third. Additional reasons have been mentioned as: • Ease of Execution • CFDs are entered into via broker, so not normally expressed • We are a brokerage institution and we do not have any responsibility for the discretionary management or advising clients in relation to their portfolios. Therefore there are no formal ongoing discussions whereby clients express their reasons • The rationale for entering into a CFD is not always given however we do not enter into cash settled CFD positions if the intention of the client is to stake build as 1) this would put our Exempt Principal Trader status at risk and 2) the instrument only gives economic exposure to the security in question, not the legal right to the underlying security
Q7 What is the primary reason your clients express for entering into CFDs? (please select main reason) 5 said They don't ask, are unaware 4 said Leverage 1 said Operation efficiency 1 said Ability to go short/long 1 said Avoid stamp duty 1 said Stake building?	Comment: Most participants selected Leverage as the main reason clients enter into CFDs.
Q8 Does the answer to the previous question differ based on the type of client? 5 said Yes 8 said No	Comment: Those who said yes explained as follows: • Anonymity from other market participants is an important factor for hedge funds. • 'The primary reason will vary depending on the clients' use of CFDs • 'It depends on the client's strategy and on the significance of the leverage • We believe that other financial institutions mainly represent underlying clients who are

	likely to be most attracted to CFDs for leverage opportunity. The hedge fund community will have more diverse reasons depending on the nature of the fund and its objectives

Q9 Do you have a specific trading desk entering into CFDs with the external market?	Comment:
 10 said Yes 3 said No	77% said Yes 23% said No
Q10 If no please indicate which desks undertake CFD trading? (XY has been used to hide the company names in the answers) • XY Direct • XY Securities • General Brokerage • XY Touch CFDs These are all operating divisions within XY Financial CFD trading is undertaken by the Equity Distribution European Sales Trading Desk and by the European Cash Desk	**Comment** Those who indicated that they do not have a specific CFD trading desk, mainly use their securities, brokerage or other trading divisions for that activity.

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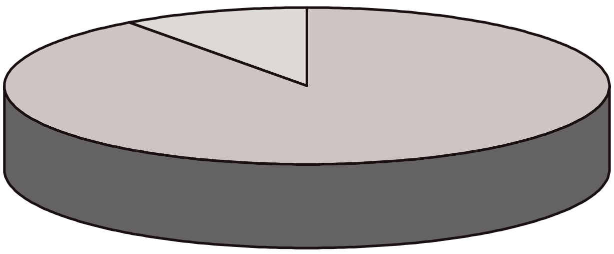
Q11 Is there a documented policy to capture the controls and procedures around the CFD business?



12 said Yes
1 said No

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Comment:

92% said Yes

8% said No

All but one participant answered that they have documented policy to capture the controls around CFD trading.

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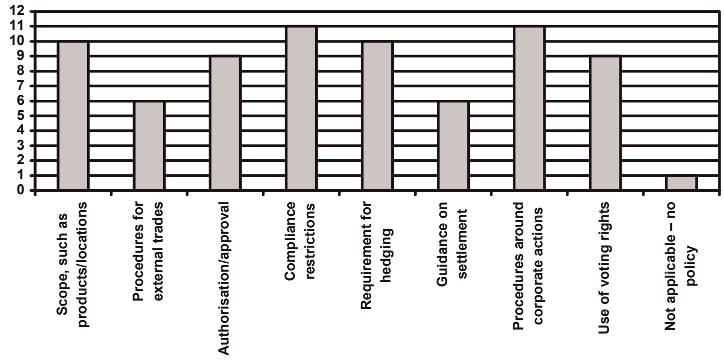
Q12 If applicable please describe what subjects are covered by your policy.

Number of votes



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Comments:

Policies seem to cover most areas listed in our question with most emphasis on “compliance restrictions” and “procedures around corporate actions” based on the answers.

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Q13 Are there any circumstances in which your policy would prevent you executing a client CFD trade?

All participants answered Yes.

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Q14 The explanations were as follows:	Comments:
• Various reasons, the firms restricted trading list, transaction size, and position size. • We may be restricted in trading the security in question for a variety of reasons particularly if we are advising or are connected to M&A activity relation to that security. Whilst that would not preclude us from entering into a cash settled CFD contract, this product is a delta one hedged product and therefore we would be prohibited from effecting our hedge as we would not be able to trade the underlying stock. • Internal restricted list or AML restrictions, sensitive industries, conflicts of interest policy. • Non exhaustive examples: Where credit limits are exceeded; For certain illiquid securities; Where restrictions are imposed by Compliance to manage conflicts of interest or to avoid a disclosure threshold breach; If there is a suspicion that the transactions might involve market abuse. • Credit constraints, stock concentration, hedging limitations, restricted stocks • The most common reason would be an internal restriction on the stock, which could arise for a number of reasons, e.g. us acting as adviser to a hostile takeover bid. • There is no formally documented policy specific to CFDs. However, there are other wider range documented policies and procedures applicable to this business such as the Global Grey & Restricted List Procedures, the IB Global Suitability Policy, the Disclosures Regime dictated by the Transparency Directive and the City Code on Takeovers and Mergers etc. This is the approach that has been taken: CFD Positions within our bank are written by the Swaps desk in London. These positions are hedged as appropriate, although generally on a delta 1 basis. In-house hedge positions are executed by the relevant sector traders. These hedge positions are proprietary.	As a summary, the most frequent reasons for a policy preventing the participants executing a CFD trade are: • Restricted client, size, type of position, industry • Internal conflict of interest with other transactions • Credit limits, thresholds • Stock restriction, stock concentration, group holding limits • Compliance issues • Inability to hedge

• Clients may be consulted with respect to their economic position under the CFD, but they have no right over the underlying hedge (if any). Our bank itself decides the nature, extent and term of such hedges and, as these are proprietary positions, our bank makes its own decisions on the exercise of associated voting rights. • We would be prevented from executing a client CFD trade in case of non compliance with any of the above mentioned policies and procedures. • There are several reasons, such as internal conflict, security could be subject to an internal restriction or the size of the transaction would exceed the client's limit. • There are a number of instances in which our policies would prohibit us from entering trades. One such example would be if a client wishes to trade in a size above allowable limits. • Such limits could relate to our risk exposure or the client's credit limits. Or, for example, we have a requirement that the firm cannot notionally own more than 10% of any company, and any client cannot own more than 1% of any company (unless we give an exemption in which case a client can own up to 8% of a company; only 3 clients have ever received this exemption). • Internal restrictions, Internal Group Holding Policy, Market Limitations • Where aggregated group holdings in terms of the underlying stock prevented hedging of the CFD trade • Where there are group restrictions re shorting a stock • Where the underlying stock is on a proprietary trading restricted list • Where there is inability to hedge due to liquidity of underlying • Where client risk limits prevent dealing	

Q15 Please provide an indication of CFD volumes in an average month?

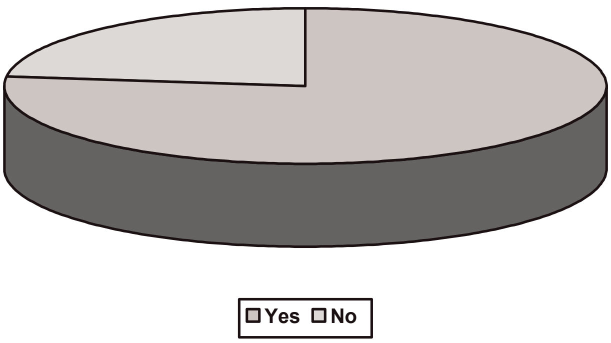
Company	Average new contracts per month	Largest contract value in £ in 2006	Average contract value in £ in 2007
1	923	49,000,000	93,451
2	4,819	68,600,000	127,374
3	1,300	10,000,000	No average could be specified but can range from several thousands to millions
4	77,000	26,750,000	42,001
5	34,000	7,455,100	30,327
6	45	34,800,000	946,800
7	22,000	525,333,836	1,295,675
8	36,000	125,000,000	150,001
9	Proprietary and confidential	Proprietary and confidential	Proprietary and confidential
10	no response	no response	no response
11	no response	no response	no response
12	no response	no response	no response

Comment:

Contracts varied from 45-77,000 per month.

Largest contract values ranged from £ 7m – £525m. The monthly average values ranged from £30k - £1.3m.

Q16 Do you generally see an increase in CFD trading volumes on a given underlying around the time of corporate events, e.g., earnings announcements/takeovers etc



10 answered Yes
3 answered No

Comment:

77% said Yes

23% said No

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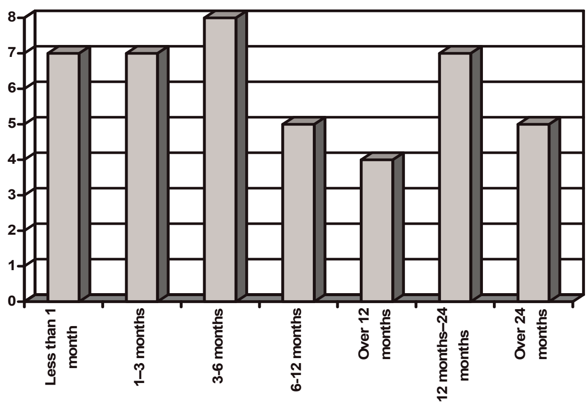
Q17 What maturities of CFD do you enter into? (please tick all that apply)

Number of votes



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Comment:

CFDs with 3-6 months maturity are most widely used and with “Over 12 months” the least.

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Q18

Of those listed maturities 1-3 and 3-6 months were ranked on the top.

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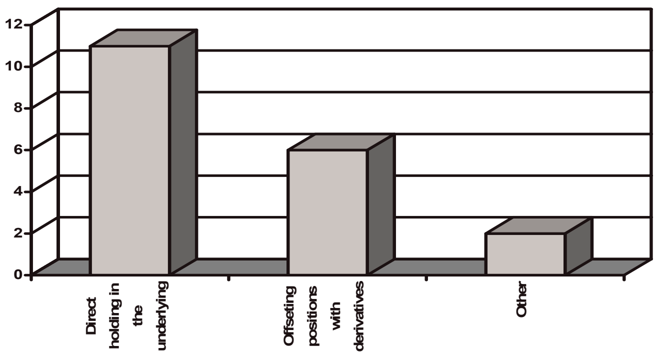
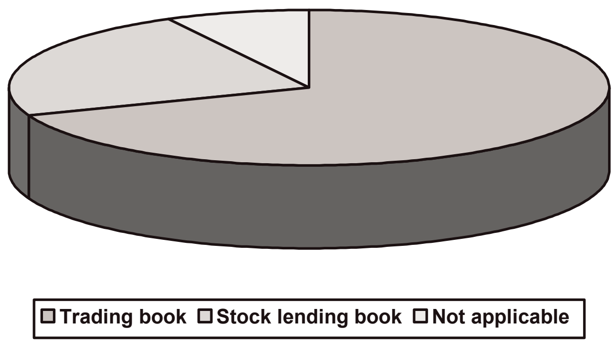
Hedging Policies

Q19 Do you hedge your CFD exposures? All participants answered Yes	
Q20 If yes how are they hedged? Number of votes 	Comment: Some respondents hedged in more than one way. 85% said they sometimes hedge with the underlying asset, 46% with offsetting positions and 15% in some other way. During the interviews most participants said they apply various, direct holdings in the underlying shares, as well as various other derivative contracts.
Q21 Where a CFD is hedged directly using the underlying stock how is this stock held during the term of the hedge? (please select)  9 answered Trading book 3 answered Lending book 1 answered N/A	Comment: 69% said in the trading book, 23% said in the stock lending book, 8% chose N/A.

Q22 To what extent are physical holdings in the underlying disclosed to the market during the period?	Comments:
• Where required under applicable disclosure rules. • Only when required under the relevant rules • A hedge position would be disclosed, along with other trading book holdings, if it increased above, or reduced below, a position disclosure threshold as per the country rules applicable to the stock. A holding would also be disclosed, if other rules, such as those relating to takeovers were applicable to the particular stock. • They are all disclosed as required by regulation • N/A - only hold via derivatives • In accordance with POTAM and Transparency Rules • The firm does not have any physical holdings in the underlying securities • As required under official reporting • We report executions in relation to CFD transactions as required under LSE rules, and also make major shareholding disclosures as required since the implementation of the Transparency Directive on 20 January 2007. • In addition to meeting our trade reporting obligations we would comply with any holding disclosure obligation to which it is subject. • disclosed in accordance with newly implemented Transparency Directive rules • As with all holding would disclose the holding where it exceeds a disclosable threshold • As required by DTR 5	Most participants said, in their disclosures, that they would fully follow any Transparency Rules and disclosure requirements prescribed to them.

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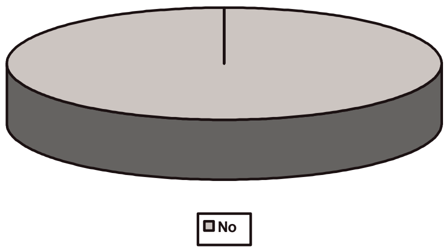
<td>Q23 Do your standard CFD sale documents contain any provisions with regard to settlement of the contract in the underlying stock if the counterparty or yourself so chooses?


13 answered No</td>
<td>Comments:
All said No to this question.</td>
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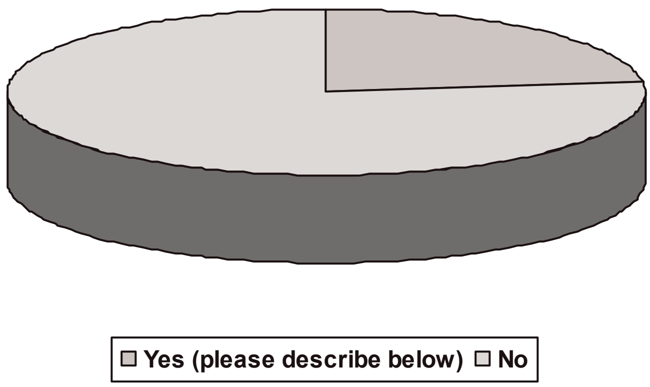
<td>Q24 Have there been any instances where your standard sale documents have been amended to include provisions with regard to settlement of the contract in the underlying stock or where side agreements have been entered into which include such provisions?


10 answered No
3 answered Yes</td>
<td>Comments:
• Firms indicated as follows:-
▪ On limited occasions, we have entered into side agreements in relation to voting rights and these contain an option to acquire the underlying hedge
▪ Extremely rare, but these are classed as physically settled and are disclosable
▪ Particularly for financing transactions where the underlying is already owned by the counterparty</td>
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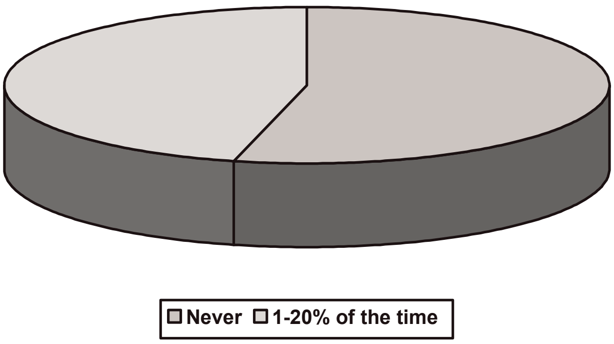
Q25 On average, how often are CFD positions closed out with physical settlement of the underlying stock?	Comments:
 7 answered Never 6 answered 1-20% of the time	54% said never, 46% said 1-20% of the time

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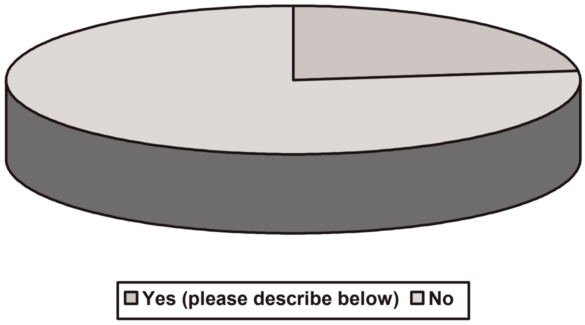
Q26 Do your standard CFD sale documents contain any provisions with regard to the ability to influence or instruct the exercise of voting rights on any underlying physical holding?



10 answered No

3 answered Yes

In order for the client to be able to influence or exercise voting rights there would have to be an express right into [our] legal documents. Such right is never present in [our] CFD sale documents.
Our standard terms of business for CFDs contain the following provision:

“You acknowledge that we will not transfer voting rights relating to an underlying share or other Instrument to you, or otherwise allow you to influence the exercise of voting rights held by us or by an agent on our behalf”.
No Influence on Voting Rights from Client

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Comment:

The sale documents might not contain that provision, but during the interviews firms all categorically said they do not vote and this would be clearly stated in their policies.
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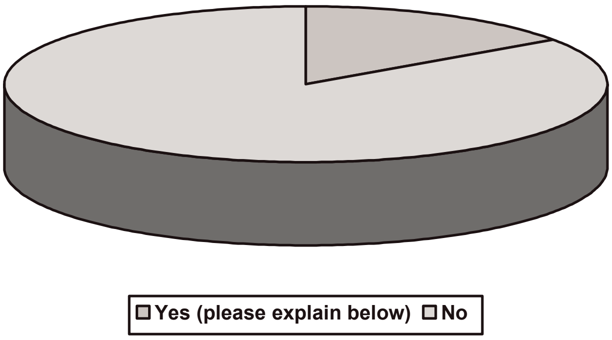
<td>Q27 Have there been any instances where your standard sale documents have been amended to include provisions with regard to control of voting rights on any underlying physical holding or where side agreements have been entered into which include such provisions?


11 answered No
2 answered Yes</td>
<td>Comments:
85% said No, 15% said Yes
Those who answered yes explained as follows:
• On limited occasions we have entered into agreements with clients whereby we agree to exercise the voting rights attached to the underlying hedge position in accordance with the clients' instructions. Such agreements are always documented.
• Mostly in relation to financing of existing positions</td>
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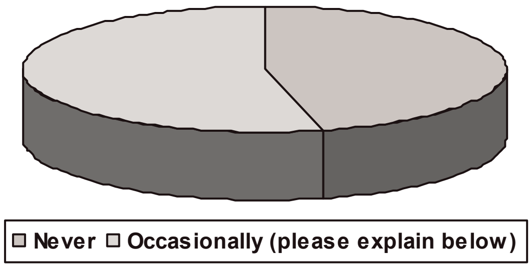
Q28 Once a CFD contract is entered into to what extent do you have non-routine communication with the holders of the CFD?



Those who answered "Occasionally" explained as below:

- If, for example, trading restrictions are imposed after the CFD has been entered into which might limit the ability of the CFD holder to execute further trades or close out existing positions.
- Mostly relate to requests to vote and actions around tenders or other corporate events
- Corporate actions such as dividends, delisting etc
- Whilst the majority of communications with clients would be routine, on occasions clients will wish to have conversations about voting rights (see answer to question 25), obtaining legal title to the underlying security and corporate actions in relation to the security in question.
- Occasional contact purely of a customer services nature (e.g.. changing customer orders, novation of transactions)
- One occasion from a Legal perspective
- 'There have been occasions where we are contacted by clients or their representatives re voting rights. Our policy is never to discuss voting rights with any third parties.

Comments:

7 answered Occasionally

6 answered Never

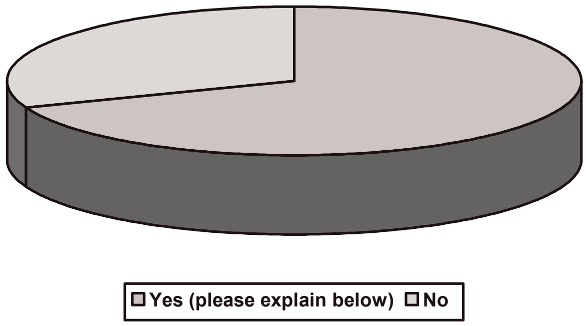
54% said Occasionally, 46% said Never

Communication mostly relates to:

- Corporate action, legal matters
- Restrictions
- Logistical issues
- Voting rights

Q29 In situations where you purchase the underlying stock as a hedge for a CFD position how are voting rights utilised during the period they are controlled?	Comments:
• We will typically vote only in respect of corporate actions. • We would not exercise the voting rights. • We have a policy not to vote on hedge positions. On rare occasions there may be a sound business reason to vote but, in these cases, approval would be required from senior Business Management and Legal/Compliance seniors • The swaps flow desk would determine whether they wanted to vote and, should they wish to do so, they would have to obtain prior approval from the Global Head of Equities. • n/a - only hedge with derivatives • so far we have not used our voting rights • n/a • Voting rights are not utilised • It is [our] policy not to allow voting on shares held to hedge CFDs. • The general policy is for us not to exercise voting rights. However, at our discretion we may vote in line with the Board's recommendation if it is in our interests to do so. We will not vote in the direction of our customers and our agreement makes that clear • We abstain from voting • Looks at voting rights across its entire inventory, hedges to CFD position are not treated separately. • It is our policy not to vote as a matter of course.	Most participants said they normally do not exercise their voting rights under their policies, but would do so if it was in their economic interest or related to corporate actions. Where they did vote, Operations or Compliance have to sign off after the desk initiates the proposal.

Q30 Have parties which are beneficiaries of an interest through a CFD ever sought to exert influence over voting rights in your physical holdings in the underlying?



Explanations:

- Rarely. In most cases any such overtures are rebuffed.
- Our CFDs confer no beneficial interest. On occasions where a client has requested the voting rights, if we are prepared to agree to the request, a formal agreement is entered into.
- Clients occasionally request us to vote a position but our policy is not to agree to any such requests
- Very Occasionally, we decline to act or discuss
- There have been occasions where we are contacted by clients or their representatives about voting rights. Our policy is never to discuss voting rights with any third parties
- Yes, but at the time it was explained to the customer that they had no control or access to the shares held by us as its hedge.
- Yes, clients have from time to time expressed a desire for us to vote in accordance with their wishes however our policies and agreements are quite clear on this point that whilst we reserve the right to vote, we will only do so if we believe it is in the best economic interests of ours. This happens very rarely.
- No our clients are aware that [we] own the rights to the underlying hedge and that we may not hold the physical
- Yes, requests are relatively common but normally refused. However, there may be exceptional circumstances where an existing holding of a client is financed by a derivative structure where we may agree to vote along with the management of the underlying company. We have not voted any shares in over a year.

Comments:

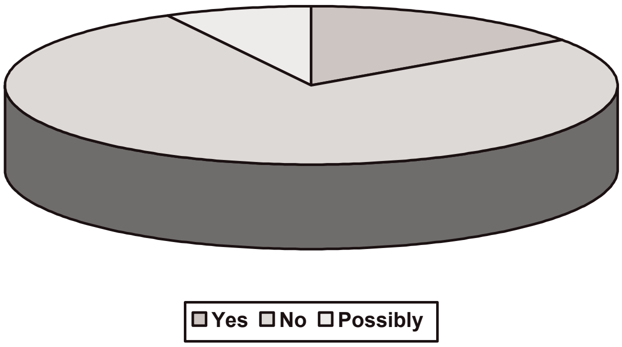
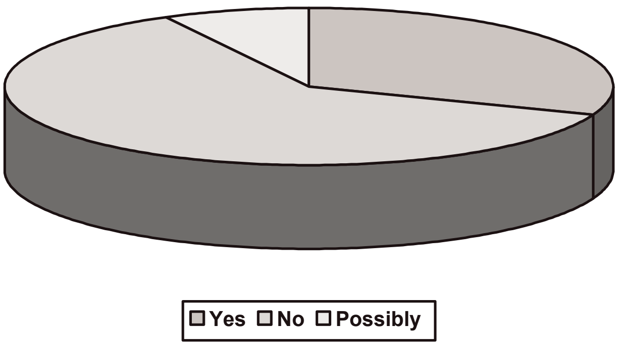
69% said Yes, 31% said No.

Explanations coincide with Q29.

9 answered Yes

4 answered No

Views on the introduction of disclosure

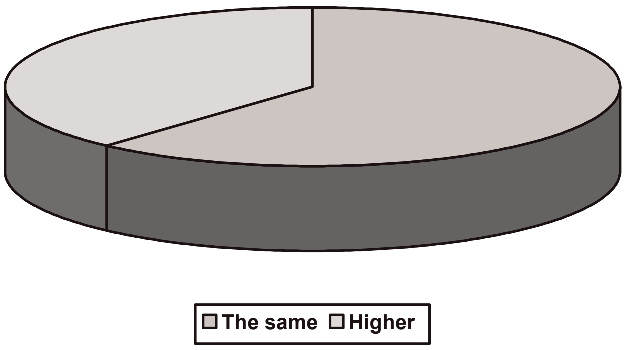
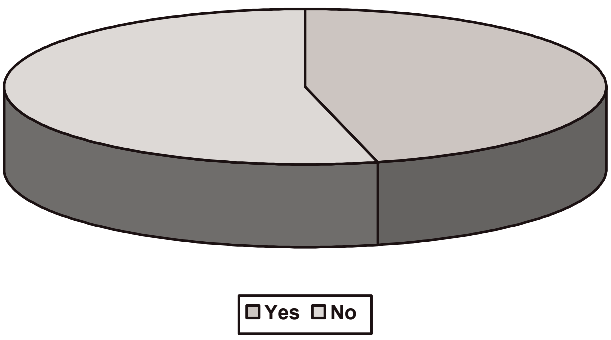
Q31 As an entity involved in the CFD market do you think that a disclosure regime outside the remit covered by the Takeover Panel is necessary?  10 answered No 2 answered Yes 1 answered Possibly	Comments: 77% said No, 15% said Yes, 8% said Possibly.
Q32 Would increased disclosure of economic interests be beneficial to the wider market?  8 answered No 4 answered Yes 1 answered Possibly	Comments: 62% said No, 31% said Yes, 8% said Possibly.

Q33 Please outline the main reasons for your response in question (32) above.	Comments:
Those who answered **No** explained as follows: • The current disclosure rules **are sufficient** to guard against anonymous stake building. • There are often arguments that more disclosure must be beneficial but this needs to **be balanced** against the potentially huge costs of implementing effective monitoring and disclosure systems and procedures. In this case the **benefits** to the market do **not** seem to be **clear** as the distinction between interests and voting rights (actual or potential) may **not** be **well understood**. The benefits of additional CFD information on some stocks would be offset by a confusing array of disclosures for many of the larger stocks. • If the Takeover Panel's approach is followed, the disclosure regime would need to be extended to **all interests** in securities, not just CFDs. Although we developed monitoring procedures for interests in stocks on the Takeover Panels Disclosure list, extending this to all UK stocks would be a considerable undertaking. • When the Takeover Panel introduced their new rules, there was some concern that there would be a proliferation of **complex** disclosures that would be difficult to understand and unhelpful to the market. We appreciate this did not materialise to a great degree but it was largely because few stocks on the disclosure list have been ones with significant trading in complex derivatives. • Most derivative disclosures related to CFDs and vanilla calls and puts but this should not be considered as representative of the whole UK market. Extension to all UK stocks would encompass FTSE100 companies, many of which have significant levels of derivative trading, including complex exotic products. This would be a **considerable monitoring burden** on both the providers of these instruments and the clients utilising them. In addition, for the larger stocks, the **complexity of disclosures** could be counterproductive in being **confusing** rather than helpful to the market. • It is unclear what market failure an extended disclosure regime would address. Whilst there may be evidence that certain hedge funds attempt to influence voting rights on hedge positions, we do **not** consider this to be **serious enough to justify the additional costs** of moving to a disclosure regime based on interests. We are not aware of	Those who said **Yes** explained as follows: • There would be a benefit whereby holdings disclosed on the new TR-1 had some form of marker indicating that a position being disclosed was held as a hedge of derivatives contracts, so the market knew that the investment was not proprietary in nature. • The benefit would come from increased transparency to the market in terms of showing the split between those who hold an economic interest and those who hold a voting interest. • Transparency for buyers in certain conditions and specific circumstances, e.g. Disclosure for stake building, limited amount of holding or purchase of underlying stock within a period of holding a CFD i.e. 10% in one week etc • Enhanced market transparency. Those who said **No** explained their answers in relation to a new regime: • It would create confusion • It would be unnecessary as the Takeover Panel rules are already sufficient • It would cause a significant cost burden • It would produce multiple counting of same shares • It would give no added benefit • The initial enhancement of the Takeover Panel rules may be lost.

• Although some hedge funds had to adapt to the new Takeover Panel disclosures, an expanded FSA regime would have a significant impact on a much wider range of funds. Panel disclosures have mainly impacted funds with M&A type strategies whereas broadening the regime would impact all funds with holdings in UK stocks. • The proposed regime is **unnecessary** for the following reasons: • it would lead to a significant increase in disclosures • **double counting** of both the CFD and the hedge reported which would lead to a lack of transparency • In our opinion it would be **confusing** to investors. It would also be **costly** and difficult to define and implement. Would this be worth the marginal increase in transparency? • Whilst there may be increased swap and other derivative activity around a takeover deal, this is the **natural result** of investors focusing on the potential price movements rather than activist funds wishing to influence the votes. • The **additional costs** of an expanded regime could lead to managers avoiding the UK market altogether • Major shareholding disclosures, as updated by the Transparency Directive, looks to voting control as a driver for disclosure, synthetic cash settled products, such as CFDs, as an investment product, only provides the holder with economic exposure to price movements. • The Takeover Panel's decision to include such products during takeover situations for disclosure purposes was a prudent approach given the ability to create dead stock by the retention of CFD hedges with connected parties, driven by activist, attempting to prevent offers succeeding. The benefit here is the transparency afforded to the market were CFD holders would otherwise go undetected. However, **outside this very specific event,** the **benefits** of including such products in holding calculations is **non-existent**.	

• In certain instances, the closing of a CFD and the resultant unwinding of a hedge may lead to situations where stocks can be bought by the original CFD holder, but this is no different to an investor buying such stock from the market/current shareholder or through a block trade executed by a broker. • The FSA should be looking to **provide rules** that restrict CFD/SWAP holders from attempting to exert or exercise control of hedge positions rather than impose additional disclosure obligation and costs on firms. • There may be **some benefits** overall provided there was clarity and an understanding of the information among investors. However, we believe the **Takeover Panel rules target the situations** where transparency is of most importance – in addition, there are certain disclosure exemptions for Recognised Intermediaries under these rules. • There is a risk that a requirement generally to disclose economic interests will lead to **confusion** and the increased possibility of "interests" relating to **multiples** of a company's total voting rights. A targeted regime which focused on where perceived abuses were taking place would be preferred. • Including such products would create confusion for the company and the market as the volume and complexity of disclosures would mask the true controllers of votes. • Additionally the perceived ownership of a company would be vastly **over inflated** resulting in a reduction of transparency of voting control. • The implementation of the TD to date has enhanced the transparency of voting control in the UK through, for example, the introduction of netting in borrowing and lending and the exclusion of collateral and short puts. **These enhancements would, in our opinion be lost** with the inclusion of cash settled product.	

Views on the introduction of disclosure

Q34 In the event that additional disclosure of economic interests was introduced do you think that the threshold for disclosure should be set:	Comments:
 8 answered The same 5 answered Higher	62% said The same, 38% said Higher.
Q35 Are you required to disclose economic interests in shares through derivatives in any other jurisdiction?	Comments:
 7 answered No 6 answered Yes	53% said No, 47% said Yes Those who answered yes added the following: • Some other jurisdictions require disclosure of potential holdings through physically settled derivatives, i.e. where there are rights to acquire voting rights. However, we are not aware of other jurisdictions requiring a broad disclosure of interests, whether conferring rights to voting rights or not • In some jurisdictions outside Europe, and those European jurisdictions which have yet to implement the transparency directive. • Hong Kong and UK Takeover Panel • Hong Kong • The disclosure regimes across EU are many and varied and there are a number of countries where disclosures of derivatives are required. As an example Italy require that a potential interest of over 5% is disclosed. • Hong Kong (not certain of exact requirements as such disclosures are made by Hong Kong office)

Q36 How much time would you estimate your organisation currently spends on monitoring and ensuring compliance with the existing Takeover Panel disclosure rules?	Comments:
• On average 1-2 hours per day • Approximately **3 hours per week** • We have a team of 4 covering Panel disclosures but they also have other disclosure responsibilities. The proportion of time on Panel disclosures will vary according to the number of Panel deals where our group is connected. • We employ one full time resource dedicated to monitoring and complying with the existing Takeover Panel Disclosures Regime. There is also regularly an additional reliance on control room headcount for support. • Because we currently enjoy an exemption from the Takeover Panel rules, our time spent would be limited to approximately 1 hour per week. This time is spent corresponding with the Takeover Panel on queries regarding our client's positions. • Extended man hours globally, 1 hour daily for each country and 1-4 hours daily reporting dependant on volume • Daily requirement - processing and preparing reports, reviewing report, dealing with queries and issues and ongoing monitoring. 10man hours a week • 2 compliance staff, 20% • 1 person, about half a day each business day. • Not taking into account the considerable development time needed to comply with the requirements one person spends all their time complying with the disclosure requirements on a daily basis • Compliance with the Takeover Panel disclosure rules is a function performed by the Control Room. At a minimum this is a **full time role for 2 people** however depending on deal flow this number can increase. • Approximately 2-3 hours per day	The time estimated spent on ensuring compliance with the Takeover Panel disclosure rules ranged from 3 - 80 man-hours per week.

Q37 What would you estimate the approximate cost of the existing Takeover Panel disclosure regime to be for your business?	Comments:
• Difficult to quantify. It is not a significant burden. • Employees and associated costs for a Compliance Executive's 3 hours per week. IT costs will be deemed "sunk costs" as they have already been incurred. • Difficult to determine as there were resource costs for setting up the procedures as well as technical work in automating some of the processes. • Approximately one million pounds annually (excluding initial system outlay.) • Approximately £10,000 per year (three times) • Cost of two staff as indicated and necessary reporting infrastructure • We have provided a cost analysis, as we are spending a lot of time focusing on other major projects, such as the implementation of MiFID. We have limited our response to confirming that it would be extensive • Difficult to take in isolation as cover EMEA region but systems, data processing and storage, and personnel costs probably up to £250,000 per annum. ▪ Approx £20,000 per annum	Most estimates were around £10,000 to £20,000 per annum, however there were £1 million and £250,000 estimates as well.

Q38 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 to be for your business?

- It really depends on how the rules are framed and whether systems can be created/amended to automatically calculate the levels of interest. There will be initial costs of systems redevelopment but the ongoing costs should not be significant subject to the ability to automate the process.
- Minimal
- Difficult to estimate incremental costs as it would not be a matter of just extending the process for the Panel disclosures. To extend to all UK stocks would require significant technology resource to examine data feeds, covering all products and rewrite monitoring systems to ensure positions could be calculated and reported correctly. In addition there would be headcount costs for the additional work in monitoring, verifying disclosable positions and making the relevant disclosures.
- It is impossible to provide a precise estimate. The upfront costs would be in the range of 5 to 10 millions pounds taking into consideration manpower, systems and education costs. There would also be ongoing annual costs associated with ensuring compliance with the expanded rules.
- The workload would more than double
- Additional ongoing costs would be approximately doubled.
- Unlikely to be marginal
- Main cost would be changing system to automate this requirement.
- Systems have been developed re reporting of this information which would need amendments – there would be initial setup costs and additional ongoing monitoring and reporting Additional ongoing costs would be approximately doubled.
- Approx 3 times the current cost £300,000 -

Comments:

The main costs would be systems related. The highest cost estimate was £5 million to £10 million Workload and ongoing costs were mostly estimated to double.

£400,000 development costs as front-end booking systems would need to be enhanced as well as compliance disclosure systems developed to enable us to accommodate increased monitoring of positions.

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CfD activity during takeover offer periods

Does CfD activity differ between takeover periods and non-takeover periods?

In this Annex we report on a comparison of substantial CfD transactions before a company goes into a takeover bid with CfD activity inside offer periods. Finding a significant and systematic increase of CfD activity in the months leading up to a takeover period may be consistent with 'covert stake building'.[29] High CfD activity could in theory be associated with significant shareholdings of over 1%, but our analysis is unable to directly link the CfD activity to size of shareholdings.

In 2005 the Code Committee of the Takeover Panel (the Panel) decided that the provisions of the Takeover Code were insufficient to address the issues arising from dealings in derivatives and options and so it amended the Takeover Code. Accordingly, under the amended Code a person is required to disclose dealings in derivatives and options, including CfDs, once a takeover bid is announced, also known as the "takeover" or "offer period". We also examined statistics on CfD activity to assess whether the introduction of the Panel regime has affected CfD activity more broadly.

This study considers the level of CfD activity per month in a sample of firms that were subject to takeovers between 2005 and 2006. Two key issues were considered:

– Is CfD activity observed during the offer period similar to the CfD activity which occurred prior to the company going into offer?

– Has there been a change in CfD activity following the introduction of the Panel regime?

The analysis shows that a significant proportion of CfD activity is concentrated during the takeover period. Although the number of CfD contracts is not very different between pre and post takeover periods, the value of CfD contracts is much greater inside the takeover period. The analysis does not indicate significant covert stake building through CfDs in the run-up to the takeovers we analyse. (Such stake building could result in a lack of competition in a takeover situation (i.e. market failure)). We also specifically considered the patterns in CfD activity for takeovers

29 On their own however, results from that analysis would not be sufficient to conclude that covert stake bulding is occuring

which were in the top 5% in terms of CfD activity. Even in such cases, there was no identifiable pattern suggesting covert stake building. Finally there were no significant effects visible of the introduction of the Panel regime.

Methodology

The FSA's transaction reporting system was used to examine information on the number and value of CfD contracts in a sample of firms that have been subject to a takeover bid since 2005. Table 1 summarises the number of firms and time periods considered in our sample. To consider potential effects of the Panel regime, we evaluated activity in three distinct periods: Period A – a period well before the Panel regime (January-March 2005), Period B – a period just before the Panel regime (May-August 2005) and Period C – a period after the Panel regime (July-September 2006). Companies involved in the first 50 takeover bids in each of these periods were examined. The reported results, however, combine all the Period A and B data (i.e. all the 2005 data) as we did not notice a difference between the two periods. We also noticed that not all firms involved in a takeover bid had activity in CfDs. For instance in 2006, of the 50 firms considered 39 had CfD activity.

Table 1 – Summary of Sample Analysed

	Total Takeover Bids	Takeovers with CfD Activity
Period A: January – March 2005	50	36
Period B: May – August 2005	50	46
Period C: July – September 2006	50	39

We obtained data on the 39 firms showing some CfD activity for up to 13 months prior to the start of the offer period. We believe that this period provides an adequate control period to examine and benchmark CfD activity outside the takeover period. The exception was with respect to Period A – the January – March 2005 period, where data were only available to a maximum of 6 months prior to the start of the offer period. We believe this shorter sample should form an adequate control period, although in a small number of cases where offer periods are preceded by several months of speculation and negotiations, it may not be entirely adequate. We keep this caveat in mind.

Figure 1 – Period of Analysis

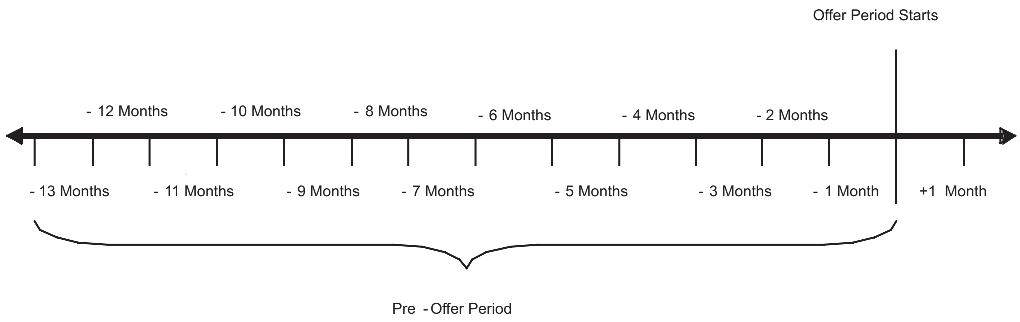


Figure 1 summarises the time-line used. Monthly activity in CfDs is considered in each of the pre-offer period months and compared with the activity in the month after the start of the takeover offer period. The two measures of CfD activity analysed are: median number and value of CfD contracts per company which is subject to a takeover bid. The analysis is on a per takeover basis and so is not affected by the variation in the number of takeovers in our sample which have CfD activity.

Results

CfD Activity Over Time: Effects of the Takeover Panel Regime

We compared the value of CfDs in Periods A and B (2005) with those in Period C (2006), and saw little change i.e. there were no significant effects visible of the introduction of the Panel regime. However, in fact there was more CfD usage (possibly in lower value amounts) in Period C (2006). For example, in the one month after the offer period starts the typical number of CfD contracts was 38 in Periods A and B (2005) and 77 in Period C (2006). This would suggest that the introduction of the Panel regime has not reduced the use of CfDs, especially in the offer period where disclosures have to be made.

Activity in Takeover versus Non-Takeover Periods

As indicated, we aggregated the results across all three of our sampled periods since there did not appear to be any significant effects on CfD activity of the introduction of the Panel regime.[30] Figures 2A and 2B summarise the median monthly number and value of for all companies in the sample. There is little change in the number of CfD contracts pre-offer period compared to the 1 month after the offer period starts. Nor does there appear to be any systematic increase in the number of CfDs in the run-up to an offer period starting. However, there is a significant change in the value of the CfD contracts which more than doubles in the month after the offer compared to the month prior to the offer. The figures indicate substantial usage of CfDs during the takeover period which is already subject to disclosure requirements. Outside the takeover period the median value of CfDs per takeover per month is much lower and ranged between 0.5 million-1 million shares in most cases. It is difficult to say from this whether this size of activity would be sufficient to allow CfD holders to garner significant equity holdings in the firm.

30 We find the same results from the separate analysis for each time period as the aggregated analysis.

Figure 2 A: CFD Activity

(median number of CFD contracts per takeover per month)

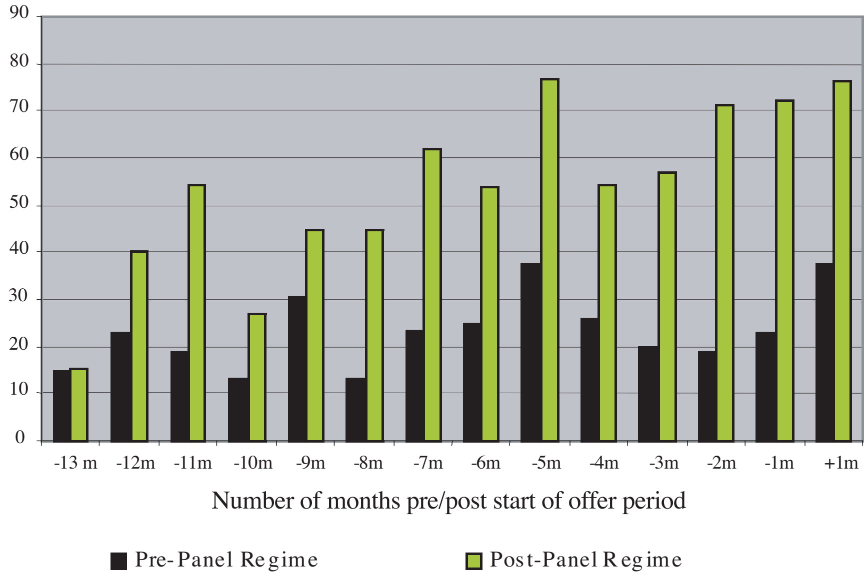
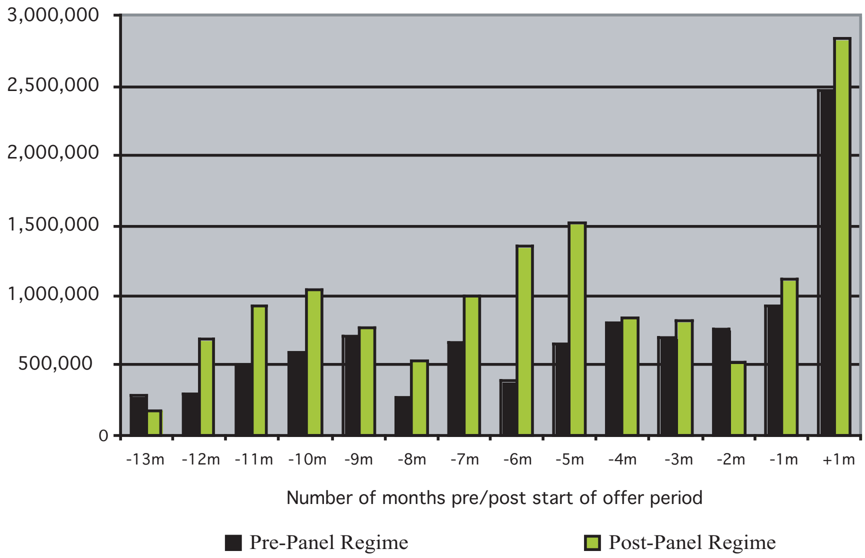


Figure 2 B: CFD Activity

(median value of CFDs per takeover per month)



The increase observed in CfD activity once a company is in an offer period would be consistent with investors seeking to reap trading gains in such a company. To assess this further we considered trends in spread bets, which do not carry the possibility of being closed out further with the underlying equity. We also found a similar increase in value of spread bet contracts once the company is in a takeover situation (see figures 3 A & B). These findings suggest that the announcement of an offer period spurs more activity in these derivative products as investors seek to take positions on the outcome of the takeover.

Figure 3 A: Comparison of CFD versus Spread Bet Activity (2006)

(median number of contracts per takeover per month)

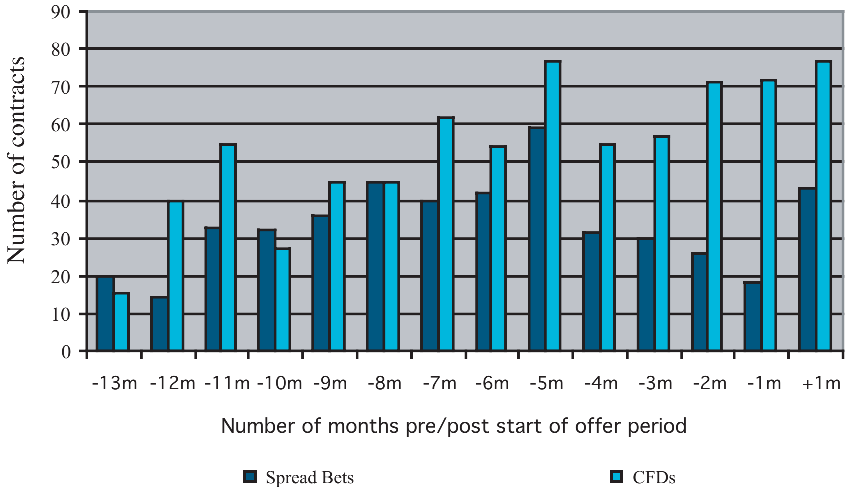
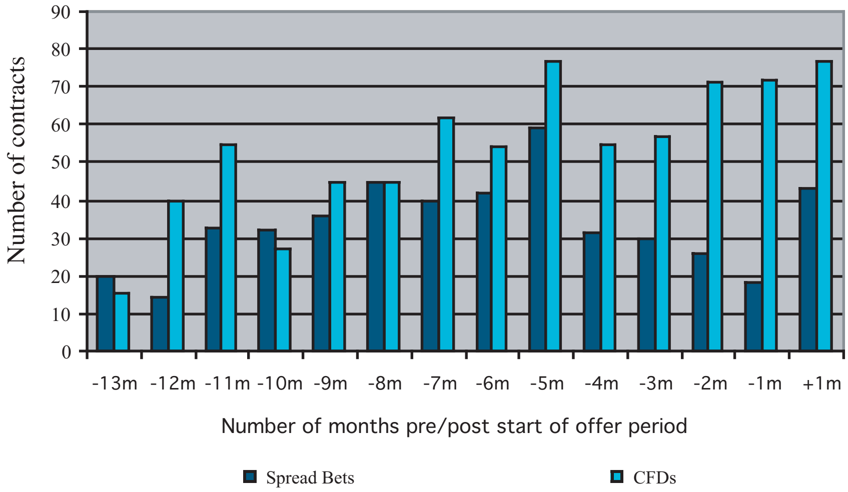


Figure 3 A: Comparison of CFD versus Spread Bet Activity (2006)

(median number of contracts per takeover per month)



High CfD Activity Cases

So far the results have considered the typical takeover. It is nonetheless possible that even if CfDs are not generally used to secretly build up stakes in companies, they may nevertheless be used for this purpose in a small number of cases, which could have economic costs. We analysed the top 5% of the takeovers as measured by the value of CfDs that were traded. Again, there was no systematic build up in the use of CfDs. Only in Period C (2006 sample), we found a dramatic increase in the value of CfDs 10-11 months prior to the start of the offer and again in the 6th month before the offer. However, it is unclear whether these spikes should be seen as purely stake-building because they could also be due to non-takeover related voting events or an anomalous data point.

Implications

The transaction level analysis of CfD activity does not indicate any systematic increase in the period usage of CfDs in the period leading up to a takeover offer. Higher value CfD contracts prior to the offer period, which would also allow firms to engage in covert stake building are not visible in the sample of takeovers that we analysed. Moreover, there was no strong indication of covert stake building even in a small sample of high CfD activity takeovers.

A significant increase in the value of CfDs takes place once the firm is in an offer period. There is also a similar increase in spread bet activity during the offer period, which would suggest that most activity is related to investors seeking trading gains.

It is possible that investors may be engaged in significant CfD activity around other, non-takeover related shareholder votes. Our analysis does not shed light on these types of activities.

Annex 6

List of Questions

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

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?

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?

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

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

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?

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?

Q10 Do you agree with our proposed approach to aggregation and thresholds for Option 2?

Q11 Do you agree with our proposed approach to aggregation and thresholds for Option 3?

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

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

Q14 Do you agree with our view on what information should be disclosed to the issuer, and how that information should be disseminated?

Q15 Do you agree with our proposal that we should seek to avoid as far as possible duplication of disclosure?

Q16: Do you agree with our approach that disclosures pursuant to the Code would negate the need for additional disclosures under the proposed CfD disclosure regime?

Compatibility with the FSA's general duties as the UK Listing Authority

1. This Annex sets out our assessment of the compatibility of the proposals set out in this Consultation Paper (CP) with the general duties conferred upon the FSA under section 73 of the Financial Services and Markets Act 2000 (FSMA) in its capacity as the UK Listing Authority (UKLA).

The need to use our resources in the most efficient and economic way

2. The proposals are consistent with an efficient and economical use of FSA resources.

The principle that a burden or restriction which is imposed on a person should be proportionate to the benefits, considered in general terms, which are expected to arise from the imposition of the burden or restriction

3. We have undertaken a cost benefit analysis to help inform this consultation (cf. Annex 1). The CBA sets out the costs and benefits of our proposals. We have pre-consulted with the market to ensure as far as possible that the burdens and restrictions imposed on issuers and other stakeholders are proportionate to the benefits.
4. Stakeholders may have different views over the nature and extent of some of the impacts we have covered. We would therefore welcome the input from respondents of any additional information that would help us quantify these impacts.

The desirability of facilitating innovation in respect of listed securities

5. Our requirement for disclosure of CfDs should not have an impact on possible future innovation in respect of listed securities.

The international character of capital markets and the desirability of maintaining the competitive position of the UK

6. Our proposal reflects global development in CfD disclosure, and should not harm the UK's competitive position. However, we are keeping an open mind, and would welcome responses from readers on this.

The need to minimise the adverse effects on competition of anything done in the discharge of the FSA's functions

7. The cost benefit analysis undertaken (see Annex 1) does not suggest there to be any adverse effects on competition.

The desirability of facilitating competition in relation to listed securities

8. Not required.

Appendix 1 – Final Handbook Text (effective September 2008)

OPTION 2

DISCLOSURE AND TRANSPARENCY RULES (DISCLOSURE OF ECONOMIC INTERESTS) INSTRUMENT 2008

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 73A (Part 6 Rules);
(2) section 89A to 89G (Transparency obligations); and
(3) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [September] 2008.

Amendments to the Handbook

D. The Disclosure Rules and Transparency Rules sourcebook (DTR) is amended in accordance with the Annex to this instrument.

Citation

E. This instrument may be cited as the Disclosure and Transparency Rules (Disclosure of Economic Interests) Instrument 2008.

By order of the Board
[ ] 2008

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text.

Insert the following new definition in the appropriate alphabetical position:

comparable financial instrument	(in *DTR*): (i) a *transferable security*; or (ii) an *option*, *future*, *swap*, *forward rate agreement* or *derivative* contract, as referred to in Section C of Annex 1 of *MifID*, having similar economic effect to a qualifying *financial instrument* in *DTR* 5.3.1 R(1) (but not including any such instrument) whether or not the *financial instrument* having similar economic effect results in an entitlement to acquire *shares*.

Annex B

Amendments to the Disclosure Rules and Transparency Rules sourcebook (DTR)

In this Annex, underlining indicates new text and striking through indicates deleted text.

5.1.2 R Subject to the exemption for certain third country *issuers* (*DTR* 5.11.6R), a *person* must notify the *issuer* of the percentage of its voting rights he holds as *shareholder* or through his direct or indirect holding of qualifying or *comparable financial instruments* falling within *DTR* 5.3.1R (or a combination of such holdings excluding *comparable financial instruments* notifiable solely upon an *issuer's* reasonable request) if the percentage of those voting rights:

(1) reaches, exceeds or falls below 3%, 4%, 5%, 6%, 7%, 8%, 9%, 10% and each 1% threshold thereafter up to 100% (or in the case of a non-UK *issuer* or a *person* holding a *comparable financial instrument* notifiable upon the reasonable request of an *issuer* on the basis of thresholds at 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%) as a result of an acquisition or disposal of *shares* or *financial instruments* falling within *DTR* 5.3.1R or, where relevant, as at the date of receipt of an *issuer's* reasonable request (unless the notification would be the same as that following the last request).

…

…

5.3.1 R (1) A *person* must make a notification in accordance with the applicable thresholds in *DTR* 5.1.2R:

(a) in respect of any qualifying *financial instruments* which they hold, directly or indirectly, which result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, *shares* to which voting rights are attached, already issued, of an *issuer*~~.~~; or

[**Note:** article 13(1) of the *TD*]

(b) unless (3) applies, in respect of any *comparable financial instrument* which, directly or indirectly, the *person* holds, in either of the following circumstances:

(i) the *person* has received a reasonable request from an *issuer* relating to that *person's* holding (if any) of such an instrument;

(ii) the non-disclosure conditions in (2) are not, or no longer continue to be, satisfied.

(2) The non-disclosure conditions referred to in (1)(b)(ii) are:

(a) the terms of the *comparable financial instrument*, and any related agreements between the holder and the provider, in relation to *shares* in an *issuer* to which the instrument is in any way related or referenced, expressly:

(i) preclude the holder from exerting any influence over the voting rights in the *issuer* to which the provider of the instrument has, or may at any time during the term of the instrument have, access; and

(ii) acknowledge the absence of any arrangements or understanding, and contain an agreement not to enter into any arrangements or create or give rise to any understanding, anticipating the potential acquisition, by the holder, on, or shortly after, expiry of the instrument, of *shares*, or the benefit of *shares*, in the *issuer* which the provider of the instrument has acquired or otherwise obtained access to, or may do so, for any purpose in connection with the instrument;

(b) the terms in (a) have not been breached and do not amount to misrepresentations (whether or not those provisions would be enforceable between the parties);

(c) the instrument holder has declared in writing to the provider, on or before entry into the *comparable financial instrument*, a genuine intention, which continues to be accurate, not to acquire, or otherwise obtain access to, *shares* in the *issuer* which the provider of the instrument has acquired or otherwise obtained access to, or may do so, for any purpose in connection with the instrument.

(3) Paragraph (1)(b) does not apply if public disclosure has already been made of information regarding the same transactions (whether or not to the same level of detail) pursuant to the *Takeover Code*.

(4) For the purposes of *DTR* 5.3.1 R(1)(b)(i) a reasonable request is one which satisfies the following conditions:

(a) it is based on the *issuer's* knowledge or reasonable cause to believe that the *person* has an interest in the *issuer's shares* by virtue of that *person's* holding (directly or indirectly) of a *comparable financial instrument* or has changed the level of the interest held;

(b) an adequate explanation of the knowledge or reasonable cause to believe is set out in the request; and

(c) it requests that the *person* either notifies the *issuer* of its holding in accordance with applicable thresholds or confirms to the *issuer* either that:

(i) it does not have such a holding above the 5% threshold; or

(ii) any such notification would be the same as that following the last request from the same *issuer*;

(d) it is not vexatious or frivolous, and does not duplicate previous requests without reasonable cause.

5.3.2 R For the purposes of *DTR* 5.3.1 R(1)(a):

(1) ~~*T*~~*transferable securities* and *options* …

…

5.3.3 G (1) For the purposes of *DTR* 5.3.1 R(1)(a) and to give effect to Directive 2004/109/EC (TD), qualifying financial instruments…. Consequently, qualifying financial instruments …

(2) For the purposes of *DTR* 5.3.1 R(1)(b), in the *FSA*'s view a *comparable financial instrument* has a similar economic effect to a qualifying *financial instrument* in *DTR* 5.3.1 R(1)(a), if its terms are in any way related or referenced, in whole or in part, to an *issuer's shares*, and, generally, the holder of the *comparable financial instrument* has, in effect, a long position on the economic performance of the *shares*.

(3) (a) In the *FSA's* view, for the purposes of DTR 5.3.1 R(4) an *issuer* may have reasonable cause to believe that a *person* may hold an interest in the *issuer's shares* by virtue of their holding a *comparable financial instrument* in the following non-exhaustive list of circumstances:

(i) if the *person* approaches the *issuer* (directly or indirectly) attempting to influence its management on the basis, in part or whole, of the *person's* holding of a *comparable financial instrument*; claiming to have access to or control over a material proportion (in the *issuer's* reasonable view) of *shares* or voting rights in the *issuer*, or otherwise implying that the *issuer* should have regard to the holder's interest;

(ii) if the *issuer* is aware of significant press speculation or market rumour (not instigated by the *issuer* itself) identifying the *person*, for a particular reason over and above that *person's* status as a particular type of *firm*, as potentially interested in gaining access to or control over a material proportion of the *shares* or voting rights of the underlying *issuer* by virtue of its holding of *comparable financial instruments* and the *issuer* has made reasonable endeavours to satisfy itself that the speculation or rumour is not frivolous or vexatious.

(b) A form ([to be completed]) which may be used to send reasonable requests to persons for the purposes of *DTR* 5.3.1 R(4) is available on the FSA's website at [to be completed].

(c) For the purposes of *DTR* 5.3.1 R(4)(d) an *issuer's* request is unlikely to be reasonable if the *issuer* has already sent a reasonable request to the same *person* and there has been no material change in circumstances to warrant the sending of a further request. Multiple requests in a relatively short period based on substantially similar press speculation or market rumour may tend to indicate that an *issuer* does not have reasonable cause to believe that the *person's* position has changed sufficiently to avoid duplication with previous requests.

(4) For the purposes of *DTR* 5.3.1 R(2)(a), the terms of the *comparable financial instrument* should be considered as a whole including any side letters or agreements which may affect the terms. Reference to a 'provider' of a *comparable financial instrument* includes any provider or issuer of such an instrument and includes, for example, a writer of a *CFD*.

(5) For the purposes of DTR 5.3.1 R(2)(a):

(a) 'arrangements' includes (but is not limited to) any discussions between the holder and the provider about the possibility of the disposal on , or shortly after maturity, of relevant *shares*; and

(b) 'understanding' includes (but is not limited to) any formal or informal understanding including that based on a firm or clear expectation arising in the circumstances.

5.3.4 R The holder of qualifying *financial instruments* and *comparable financial instruments* (excluding *comparable financial instruments* notifiable solely upon an *issuer's* reasonable request) is required to aggregate and, if necessary, notify all such instruments as relate to the same underlying *issuer*.

…

…

5.7.1 R Unless 5.7.1AR applies, ~~A~~ a person making a notification in accordance with *DTR* 5.1.2 R must do so by reference to each of the following:

(1) the aggregate of all voting rights which the *person* holds as *shareholder* and as the direct or indirect holder of qualifying and *comparable financial instruments* (excluding *comparable financial instruments* notifiable solely upon an *issuer's* reasonable request);

…

(3) the aggregate of all direct and indirect holdings of qualifying and *comparable financial instruments* (excluding *comparable financial instruments* notifiable solely upon an *issuer's* reasonable request).

5.7.1A R A person making a notification of *comparable financial instruments* upon an *issuer's* reasonable request must do so by reference to the aggregate of direct and indirect holdings of all such *comparable financial instruments* as relate to the same underlying *issuer*.

5.7.2 G The effect of *DTR* 5.7.1R is that a *person* may have to make a notification if the overall percentage level of his voting rights (ignoring for these purposes *comparable financial instruments* notifiable solely upon an *issuer's* reasonable request) remains the same but there is a notifiable change in the percentage level of one or more of the categories of voting rights held. *DTR* 5.7.1AR makes clear that *comparable financial instruments* notifiable solely upon an *issuer's* reasonable request are not aggregated with other types of notifiable interest, but are aggregated only with all such other *comparable financial instruments* as relate to the same underlying *issuer*.

5.8.2 R (1) A notification required of voting rights arising from the holding of qualifying or *comparable financial instruments* must include the following information:

…

(f) … ; ~~and~~

(g) name of the underlying *issuer*~~.~~; and

(h) in the case of a *comparable financial instrument* notifiable upon an *issuer's* reasonable request, the reasons given by the *issuer* for sending the request.

…

5.8.3 R The notification to the *issuer* shall be effected:

(1) as soon as possible, but not later than four *trading days* in the case of a *non-UK issuer* and two *trading days* in all other cases, the first of which, unless (2) applies, shall be the day after the date on which the relevant *person*:

(~~1~~a) …

(~~2~~b) …

(2) in relation to a notification of a *comparable financial instrument*:

(a) following an *issuer's* reasonable request, the first *trading day* shall be the day after the date on which the relevant *person* receives the reasonable request; and

(b) where the 'non-disclosure' conditions in *DTR* 5.3.1(1)(b)(ii) are relied upon the first *trading day* shall be the day after the date on which the conditions no longer continue to be satisfied.

…

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…

(1)	(2) Material to which the transitional provisions applies	(3)	(4) Transitional Provisions	(5) Transitional provisions: dates in force	(6) Handbook provision: coming into force
…					
14	DTR 5.3.1(2)(b)	R	The notification requirement arising under DTR 5.3.1(2)(b) does not apply to *comparable financial instruments* entered into prior to the date in column (6).	[September 2008]	[September 2008]

OPTION 3
DISCLOSURE AND TRANSPARENCY RULES (DISCLOSURE OF ECONOMIC INTERESTS) INSTRUMENT 2008

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 73A (Part 6 Rules);
(2) section 89A to 89G (Transparency obligations); and
(3) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [September] 2008.

Amendments to the Handbook

D. The Disclosure Rules and Transparency Rules sourcebook (DTR) is amended in accordance with the Annex to this instrument.

Citation

E. This instrument may be cited as the Disclosure and Transparency Rules (Disclosure of Economic Interests) Instrument 2008.

By order of the Board
[ ] 2008

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Insert the following new definition in the appropriate alphabetical position:

comparable financial instrument	(in *DTR*): (i) a *transferable security*; or (ii) an *option*, *future*, *swap*, *forward rate agreement* or *derivative* contract, as referred to in Section C of Annex 1 of *MifID*, having similar economic effect to a qualifying *financial instrument* in *DTR* 5.3.1 R(1) (but not including any such instrument) whether or not the *financial instrument* having similar economic effect results in an entitlement to acquire *shares*.

Annex B

Amendments to the Disclosure Rules and Transparency Rules sourcebook (DTR)

In this Annex, underlining indicates new text and striking through indicates deleted text.

5.1.2 R Subject to the exemption for certain third country *issuers* (*DTR* 5.11.6R), a *person* must notify the *issuer* of the percentage of its voting rights he holds as *shareholder* or through his direct or indirect holding of qualifying or *comparable financial instruments* falling within *DTR* 5.3.1R (or, for interests other than *comparable financial instruments*, a combination of such holdings) if the percentage of those voting rights:

(1) reaches, exceeds or falls below 3%, 4%, 5%, 6%, 7%, 8%, 9%, 10% and each 1% threshold thereafter up to 100% (or in the case of a non-UK *issuer* or a *person* holding a *comparable financial instrument* on the basis of thresholds at 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%) as a result of an acquisition or disposal of *shares* or *financial instruments* falling within *DTR* 5.3.1R.

…

5.3.1 R (1) A *person* must make a notification in accordance with the applicable thresholds in *DTR* 5.1.2R:

(a) in respect of any qualifying *financial instruments* which they hold, directly or indirectly, which result in an entitlement to acquire, on such holder's own initiative alone, under a formal agreement, *shares* to which voting rights are attached, already issued, of an *issuer*~~.~~; or

[**Note:** article 13(1) of the *TD*]

(b) unless (2) applies, in respect of any *comparable financial instrument* which, directly or indirectly, the *person* holds.

(2) Paragraph (1)(b) does not apply if public disclosure has already been made of information regarding the same transactions (whether or not to the same level of detail) pursuant to the *Takeover Code*.

5.3.2 R For the purposes of DTR 5.3.1R(1)(a):

(1) ~~T~~*transferable securities and options*, qualifying financial instruments…. Consequently, qualifying financial instruments … …

…

5.3.3 G (1) For the purposes of *DTR* 5.3.1R(1) and to give effect to Directive 2004/109/EC (TD) …

(2) For the purposes of *DTR* 5.3.1R(1)(b), in the *FSA*'s view a *comparable financial instrument* has a similar economic effect to a qualifying *financial instrument* in *DTR* 5.3.1R(1)(a), if its terms are in any way related or referenced, in whole or in part, to an *issuer's shares* and, generally, the holder of the *comparable financial instrument* has, in effect, a long position on the economic performance of the *shares*.

5.3.4 R The holder of qualifying *financial instruments* is required to aggregate and, if necessary, notify all such instruments (not including *comparable financial instruments*) as relate to the same underlying *issuer*. The holder of *comparable financial instruments* must aggregate and, if necessary, notify all *comparable financial instruments* held as relate to the same underlying *issuer*.

5.3.5 G The effect of *DTR* 5.3.4R is that qualifying *financial instruments* are to be aggregated with other qualifying *financial instruments* as relate to the same underlying *issuer* but should not be aggregated with *comparable financial instruments*. The holder of *comparable financial instruments* is required to aggregate and, if necessary, notify all such *comparable financial instruments* as relate to the same underlying *issuer*, but such instruments should not be aggregated with qualifying *financial instruments* (nor, by virtue of *DTR* 5.1.2R, should they be combined with any other holdings).

5.7.1 R Unless 5.7.1AR applies, ~~A~~ a person making a notification in accordance with *DTR* 5.1.2R must do so by reference to each of the following:

(1) the aggregate of all voting rights which the *person* holds as *shareholder* and as the direct or indirect holder of qualifying *financial instruments*;

…

(3) the aggregate of all direct and indirect holdings of qualifying *financial instruments*.

5.7.1A R A *person* making a notification of *comparable financial instruments* must do so by reference to the aggregate of direct and indirect holdings of all such *comparable financial instruments* as relate to the same underlying *issuer*.

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