Contracts for Difference

A response by

CFA Society of the UK

About CFA Society of the UK

The CFA Society of the UK (CFA UK), formerly UKSIP, represents the interests of around 7,000 leading members of the investment industry. The society, which was founded in 1955, is one of the largest member societies of the CFA Institute and is committed to leading the development of the investment industry through the promotion of the highest ethical standards and through the provision of education, professional development, advocacy, information and career support on behalf of its members. CFA UK supports the CFA, ASIP, a recognized qualification of CFA Institute, and IMC designations. Most members hold either the Chartered Financial Analyst (CFA), or Associate of the Society of Investment Professionals (ASIP) designation. The ASIP designation is held by those who successfully completed the Associate examinations. CFA Institute is best known for developing and administering the CFA curriculum and examinations and issuing the CFA charter. CFA Institute's mission is to lead the investment profession globally by setting the highest standards of ethics, education and professional excellence.

The CFA Institute Centre represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

Most CFA UK members also belong to the CFA Institute and reaffirm annually their adherence to its Standards of Professional conduct. Both CFA UK and CFA Institute are committed to providing members with a wide range of professional development opportunities. All members are encouraged to undertake ongoing post-qualification professional development.

CFA UK is the awarding body for the IMC, the benchmark entry-level qualification for those working in investment management in the UK. The examination is accredited by the Qualifications and Curriculum Authority (QCA) and is designated an 'appropriate examination' by the Financial Services Skills Council (FSSC) for the purposes of the

Financial Services Authority's training and competence requirements. The IMC is held by over 15,000 investment professionals.

About this response

CFA UK and the CFA Centre welcome the opportunity to respond to this consultation on behalf of our members. As investors we consider that change in the regulatory regime for the disclosure of CfDs, a rapidly growing and relatively new area of business is overdue but, equally, we share the FSA's desire for a proportionate response without unnecessary bureaucracy or costs which can prove to be counterproductive. We, therefore, welcome the FSA's approach and the careful consideration that it has given to the issue of whether opacity actually causes harm. The society believes that CfDs are useful tools and that the growth of their use is testimony to the powerful innovative forces at work in the financial community. The society endorses the FSA's view, as expressed in paragraph 5.23, that the concerns at issue are solely about the delineation of a regime for appropriate disclosure and governance.

When preparing our response we conducted a survey of our members' views. We received over 300 replies which delivered a very clear message. Over 80% believed that the current disclosure regime should be changed. An overwhelming 93% supported the disclosure of substantial economic interests subject to certain thresholds unless the holder has taken specific steps to preclude themselves from exercising influence over the underlying shares. 87% were in favour of disclosure of all economic interests held through CfDs and other derivatives above a 5% threshold. This, together with other written comments from members has been used to inform our response.

In summary, we wholeheartedly support the need to change. We are unconvinced that there are substantial differences in the costs between the two options proposed (see response to question 12). We are, therefore, in favour of option 3, believing it to be a clearer and more robust regulation which will be more difficult for CfD holders and issuers to circumvent. Furthermore, option 3 is consistent with the regulatory requirements for other similar instruments.

Response to questions

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

The society agrees with the concerns identified. In addition, the society would like to note that, in addition to the problem identified in paragraph 3.21 regarding the cost of identifying owners, companies are frequently unable to identify the ownership of claims of CfD holders. This creates a situation whereby a company is unable to discuss strategic options with its large shareholders because it cannot find out who has the beneficial interest in a large part of its equity. Similarly if, say, 20% of the equity is held through CfDs which have a non-voting agreement, disproportionate power will be given to other large shareholders.

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?*

We agree that the failures identified by the FSA are correct. We have an additional concern relating to the liquidity provided by market-makers which is addressed in our answer to question 13 below.

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?*

The society agrees with the analysis although it believes it would have been preferable to base conclusions on a dataset covering 12 months at the very least.

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

Yes, the society strongly supports the view that there should be increased disclosure of CfDs.

Q5 *Do you agree that our proposed definition of comparable financial instruments, 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?*

The guidance on similar economic effects of proposals appears not to capture the potential abuse opportunities. In §1.19 the FSA clearly states that the key question is the treatment of CfDs as substitutes for physical holdings. Thus the underlying assumption is that the derivative and cash positions are both long. However, market abuse opportunities can arise from the ability of investors simultaneously to establish long voting and short economic interests, or their failure to disclose large short economic positions, and thus 'hide' the true nature of their interests.

Although there appears to be little or no evidence that such abuse has already occurred, it remains a possibility. Consequently, the society would recommend that the FSA re-examines this issue as a pre-emptive measure. One possible solution would be the disclosure of the absolute size of both long and short positions separately, once a relevant threshold had been passed.

Q6 *Do you agree that CfDs not complying with a safe harbour should be disclosed?*

We agree with this, if safe harbour conditions are to be allowed (see our answer to questions 7 and 13 below).

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?*

We agree with these conditions if safe harbour conditions are to be allowed. We are not convinced, however, that safe harbour conditions are practical or enforceable.

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

We agree

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?*

We agree

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

We agree

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

We agree

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

We are unconvinced about the scale of the costs quoted for option 3. Some of the firms seem to have indicated they might be quite marginal, others seem to take a view that the costs are very high, so this presents a quite a confusing picture for the FSA to interpret. Clearly in all these cost/benefit analysis studies there is the risk that firms over-estimate costs for changes which they do not wish to undertake and we suspect that this might be the case for option 3. The FSA mentions that other jurisdictions have already implemented similar measures along the lines of Option 3, so less subjective data on costs and benefits might be available to the FSA from these jurisdictions. The FSA notes that the introduction of these requirements has not reduced derivative trading volumes in these jurisdictions and so it appears that liquidity has been maintained.

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

The society's preferred choice is option 3. Option 2, whilst a pragmatic solution, is rather piecemeal and may be confusing to market participants in what is already a technically complex area requiring timely disclosure. This may lead to inconsistent disclosure and future regulatory problems. The Take-over Panel seems to have already considered that there are sufficient benefits in imposing a fuller disclosure regime for options and futures and the FSA itself indicates that going with option 3 would offer greater alignment. CFA UK also doubts whether it would be possible to word option 2 so that it is sufficiently legally watertight to close all possible loopholes which could undermine what the FSA is trying to achieve. We are very concerned about the potential for CfD holders to make disingenuous declarations which would undermine the regime but which would be impossible to police.

If option 2 were to be adopted, we are of the view that market-makers should declare any part of their trading book holdings which is hedged to a CfD and which exceeds 3%. These holdings change the market-maker's role from that of a trader providing liquidity with no interest in voting to that of a quasi investor. If such 'investment' holdings are sizeable the price of the underlying equity could be affected because of the impact on market liquidity and the possible effect on the pricing of large deals. In the interest of efficient price formation we believe that these events need to be reported to the market in a timely fashion.

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

We agree

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

We agree

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?*

We agree.

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