



London
STOCK EXCHANGE

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Dear Simon

**RESPONSE TO FSA'S CONSULTATION ON DISCLOSURE OF
CONTRACTS FOR DIFFERENCE**

Thank you for the opportunity to comment on FSA's proposals regarding a possible disclosure regime for Contracts for Difference (CFDs). This is an area of considerable interest to us. In our response to FSA's CP06/04 regarding implementation of the Transparency Directive in the UK, we supported further work in this area, to gather comprehensive information on market participants' opinions and of the practicalities of extending the disclosure regime to CFDs.

In assessing the issues surrounding disclosure of CFDs, FSA has been faced with a difficult task. This is inevitable since the problems related to (lack of) CFD disclosure are only the symptom of a far more significant problem, namely the seriously detrimental effect of stamp duty on UK equity market liquidity and efficiency - the imposition of which has precipitated the rapid growth and market penetration of CFDs.

Given the current situation regarding stamp duty and the creation of a relatively inefficient CFD market in the UK, we recently announced our intention to launch an Exchange-Traded CFD (ETCFD) service. Details of the ETCFD service will be available on our website in the near future. However, the important aspect to highlight here is that there will be complete anonymity between the holders of CFDs and the Prime Finance Partners (PFPs), who undertake the cash hedge position. Anonymity ensures that holders will not be able to influence voting rights or 'covertly' buy the underlying shares, as they will not know which of the PFPs holds the shares. The upshot is that, at least for ETCFDs, some of issuers' concerns may in future be alleviated. This is one example of how market solutions may develop over time, and present alternative approaches to be considered by FSA.

The consultation paper identifies a range of concerns of both issuers and market participants. As a listed company in our own right, we understand the importance of knowing who owns a substantial interest in the company. It has become increasingly important for companies to understand the views and outlook of investors, predict how they will vote on important corporate issues and to understand the intentions of large stakeholders. However the ability to do so is hampered if companies are unable to obtain a clear picture of who has influence over such interests.

Companies are also mindful of the effects that CFD trading has had on liquidity of their shares and on market efficiency. FSA estimates about 30% of equity trades are in some way driven by CFD transactions referenced to the underlying shares. The nature of our business means that such considerations are perhaps even more pertinent to us.

It is obvious that finding a solution that balances the concerns of issuers and those regarding cost and market efficiency is not an easy task.

Having considered the arguments for and against CFD disclosure at length, we agree with FSA's conclusion that some form of action needs to be taken. The existing disclosure regime does not adequately deal with certain practices involving CFDs, and a failure to act has the potential to impact on market confidence.

However, we believe that additional work needs to be undertaken before conclusions on the design of such a regime can be reached. Above all, any CFD disclosure regime - which could potentially have far reaching consequences on the market - must be carefully implemented. This would apply to either of the options put forward in the paper. We describe our specific concerns in our detailed answers set out in the appendix. We encourage FSA to further its analysis and continue its dialogue with the market before a final decision is made.

I hope our views are helpful to FSA's work. Please do not hesitate to contact me if you wish to discuss any aspect of this letter.

Yours sincerely

A handwritten signature in black ink that reads "Anita Collett". The signature is written in a cursive, flowing style.

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APPENDIX

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

We commend FSA for its efforts in identifying and describing the range of concerns of both issuers and market participants. These are broad and in some cases complex arguments, which have been presented clearly and comprehensively.

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 believe that FSA has identified a number of market failures, but due to the scope of the review, these focus on the specific concerns related to the (lack of) disclosure of CFDs. This means the task will inevitably be fraught with difficulty since disclosure is only the symptom of a far more significant problem, namely the seriously detrimental effect of stamp duty on UK equity market liquidity and efficiency.

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?

We believe that the analysis is broadly correct, but it may also be helpful to consider the wider implications of stamp duty and CFDs (see Q2).

In addition, there are some aspects where it is unclear if evidence has been obtained to illustrate why certain choices have been made. For example, under option 2, the 'flush out mechanism'¹ threshold has been set at 5%. Similarly, under option 3 the threshold for disclosure has been set at 5%. In both instances, it is not clear whether any evidence was obtained as to the suitability of these thresholds.

We believe that additional work needs to be undertaken and we encourage FSA to continue its dialogue with the market before a decision is made.

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

Yes. Concerns regarding CFD's are difficult to prove empirically, however we have heard strong views voiced by the market. Issuers are concerned that CFDs are used in order to seek to influence votes and other corporate governance matters on an undisclosed basis, and also to build up stakes in companies, without disclosure. We share FSA's belief that this is not happening on a

¹ By 'flush out mechanism' we are referring to the mechanism under option 2 for issuers, with similar effect to s793 of the Companies Act 2006, to 'flush out' holders of economic interests, as set out in paragraph 1.30 of the CP.

systematic basis. However, despite the lack of empirical evidence, the level of concern amongst issuers is such that we believe some form of action is necessary.

The existing disclosure regime does not adequately deal with certain practices involving CFDs, and a failure to act has the potential to impact on market confidence.

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?

It is very important that the scope of the proposals is correctly worded, so that they cover all instruments that raise the same issues and concerns as CFDs. We believe the wording proposed by FSA is adequate.

Q6. Do you agree that CFDs not complying with a safe harbour should be disclosed?

We agree with FSA’s reasoning that issuers should know where there are instances of CFD holders having access to voting rights or to buying the underlying shares from the CFD writer at some stage.

However, we find that we are not able to support Option 2 until important questions regarding the applicability of stamp duty to such CFDs are answered. Nor can we support this option until concerns over the viability and enforceability of the safe harbour (as currently proposed) have been addressed (see Q7).

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 do not believe that the current drafting for a safe harbour provision is sufficient. We understand issuers are concerned that CFD contracts will contain ‘boilerplate’ terms in order for CFD holders to obtain a safe harbour. Whilst such contracts would meet the ‘technicalities’ of the safe harbour, they would be very hard to police or enforce – and could, in effect, be meaningless.

We believe that FSA needs to consider how it will act where instances emerge of a CFD holder ‘changing his mind’ after agreeing to the explicit terms of the CFD contract and subsequently trying to influence voting or obtain access to the company’s underlying shares. FSA will need to explain how/if it will deal with contravention of the spirit of the rules.

Any safe harbour would have to ensure that the CFD holder cannot circumvent the terms of the contract. For example, complete anonymity between the holder and the writer of CFDs would mean that holders could not – even if they wanted to – exert influence over the writer in respect of the underlying shares, because they simply would not know who held them. As mentioned in our cover letter, one feature of our ETCFD service is anonymity between holder and writer. With this in mind, it is possible that in future, market solutions will develop and present alternative approaches to be considered by FSA.

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

If option 2 is adopted, then we agree that this provision is necessary. However, further consideration needs to go into determining ‘reasonable cause’, as outlined below.

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 with the principle that notification requests should only be made by issuers where they have reasonable grounds for believing that a person has an economic interest in their shares, and that the issuer must document these grounds when making the notification.

There is general agreement that ‘reasonable cause’ should include a direct or indirect approach made by the CFD holder, attempting to influence the issuer’s management.

However, the area of ‘press speculation’ is harder to judge. It is important that notification requests are not issued at the mere hint of a mention in the press. We understand market participants concerns, however we believe the requirement that the issuer must take reasonable steps to satisfy itself that the speculation or rumour is not frivolous or vexatious, and to document their rationale for believing this, should be sufficient. FSA must be prepared to ensure this is adhered to by issuers, and potentially issue further guidance or make amendments to the rules if it is not.

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

We agree with the disclosure threshold proposed by FSA under Option 2 (aggregated with shares, at 3%), as a higher threshold would not be aligned with the existing 3% disclosure (covering interests in shares) under the Disclosure and Transparency Rules. Therefore, this seems an appropriate level.

On the issuer flush out mechanism within Option 2, FSA has suggested that only interests over 5% must be disclosed. FSA's cost/benefit analysis to set this threshold appears weak. We suggest that further work be done through additional dialogue with the market on whether a 3% disclosure requirement would be more appropriate and helpful for issuers.

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

We believe that additional work should be done with respect to FSA's cost/benefit analysis, and on finding the appropriate threshold for disclosure. The cost/benefit analysis makes some assumptions that would benefit from further scrutiny.

In particular, the upfront systems costs to implement Option 3 seem surprisingly high, estimated to be between £20m-50m. FSA does not comment on whether systems changes already made by firms to implement the Takeover Panel regime would mean that fewer changes would be needed. With respect to the benefits of Option 3, additional work could be done to determine if a general disclosure regime for all CFDs would produce excessive, contradictory or double-counted information, causing confusion in the market as opposed to more clarity.

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

Please note our comments made above concerning the thresholds for options 2 and 3 and the systems costs associated with option 3.

With regard to the cost of corporate disclosure, this is a hard thing to predict. From our own analysis, we believe that the assumptions made by FSA look broadly realistic.

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

As stated above, we believe that additional work needs to be undertaken before conclusions can be reached. We encourage FSA to further its analysis in the areas we have identified and continue its dialogue with the market before a decision is made.

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

Yes, we agree.

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

Yes. Double disclosure could be more harmful than beneficial to the market. Any regime that is introduced will only be valuable if the disclosures are meaningful to its users. We agree that exemptions for CFD writers from disclosure, along the lines of those under DTR, should be introduced.

In addition, Prime Finance Partners under our proposed ETCFD service should also be entitled to such an exemption, since they will be undertaking the cash hedge position in this scenario.

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?

Yes. The Takeover Panel rules have worked well in the context of CFD disclosure during takeover periods. There seems no sense in having duplicative disclosure requirement, so we agree that disclosures pursuant to the Code should negate the need for additional disclosures under the proposed CFD disclosure regime.