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Investment Management Alert

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Transparency Directive II and Changes to the DTRs

Summary

On 26 November 2015, the United Kingdom's major shareholding notification rules will be amended in order to implement the requirements of the revised Transparency Directive ("TD2", as amended by Directive 2013/50/EU).

Key Changes

The changes most relevant to investment managers include:

- obligation to disclose acquisitions or disposals of major proportions of voting rights in shares of an issuer whose shares are admitted to trading on a regulated market (the "Disclosure Obligation") extended to include stock lending transactions. This will remove the current exclusion in the UK of stock lending transactions from the scope of the disclosure obligation
- a new requirement making major shareholding disclosures in respect of financial instruments that have the same economic effect as holdings of shares applicable across the European Union, introducing new categories of financial instruments to consider when assessing whether holdings will trigger a notification obligation
- new sanctions for breach of the disclosure rules, including the removal of voting rights
- extension of the investment manager exemption (which allows disclosure to be made only at the five per cent /ten per cent / higher thresholds, rather than the UK super-equivalent disclosure obligations) from US and European Economic Area (EEA) investment managers to all investment managers, regardless of their home jurisdiction.

Extension of The Disclosure Obligation To Stock Lending Transactions

Under the existing rules, the Financial Conduct Authority (FCA) has excluded stock lending transactions from the Disclosure Obligation, provided, in respect of the borrower, that the shares are on-lent or otherwise disposed of by the borrower by the close of business on the next trading day and that there has been no declared intention to exercise voting rights, and the voting rights are not actually exercised. However, the FCA has now decided to align the notification obligations under the Disclosure and Transparency Rules (DTR) in line with guidance from The European Securities and Markets Authority (ESMA) relating to disclosures under TD2. Therefore, from 26 November 2015, it will be necessary to include all lent and borrowed shares in disclosures concerning disposals and acquisitions of voting rights.

Changes to The Disclosure Obligation

Currently, the DTRs require the disclosure of acquisitions of securities of a UK issuer whose shares are admitted to trading on a regulated market (or a prescribed market), derivatives that result in an

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entitlement to acquire such voting shares, and other financial instruments, including contracts for difference, that are referenced to the shares of such an issuer and that have similar economic effects to such securities or derivatives.

Article 13(1) of the amended TD2 specifies that the Disclosure Obligation shall extend to financial instruments that have a similar economic effect to shares and entitlements to acquire shares, whether or not they give rights to physical settlement, including cash-settled derivatives.[1] The changes to the scope of the Disclosure Obligation will therefore broadly align the EU-wide requirements with the existing UK requirements under the DTRs. Managers should bear in mind the extended disclosure requirements in other EU jurisdictions that did not previously require the reporting of economically equivalent financial instruments.

Notably, the link between "financial instruments" subject to the Disclosure Obligation, and Directive 2004/39/EC (MiFID) is removed, such that "financial instruments" under the amended DTRs will be defined with reference to TD2, rather than MiFID. This will mean that there will be new types of financial instruments that must be considered when assessing whether the Disclosure Obligation is triggered with respect to an issuer.

TD2 sets out a non-exhaustive list of financial instruments that, provided they satisfy certain conditions, are included within the scope of the Disclosure Obligation.[2] In addition, ESMA has provided an indicative list of "other financial instruments" that are subject to the Disclosure Obligation. Such instruments must reference shares to which voting rights are attached, and meet certain conditions[3] set out in the DTRs. ESMA's list represents a departure from the existing parameters, as the new categories of "financial instruments" are broader than they are currently. For example, the indicative list includes within the scope of the Disclosure Obligation certain financial instruments referenced to a basket of shares or an index;[4] contractual buying pre-emption rights; combinations of financial instruments; and shareholders' agreements having their underlying financial instruments.

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[1] The disclosure in respect of cash-settled derivatives will take place on a cash-settled basis. ESMA has provided minimum standards for the delta adjustment methodology in its regulatory technical standards, which will be reproduced in the amended DTRs.

[2] Such financial instruments are transferable securities; options (calls, puts or any combination of the same); futures; swaps; forward rate agreements; contracts for differences; and any other contracts or agreements with similar economic effects which may be settled physically or in cash.

[3] The conditions will be set out in the amended DTR 5.3.1R(1)(a) and (b), and will specify that the notification obligation applies with respect to financial instruments which: (a)"on maturity, give the holder, under a formal agreement, either the unconditional right to acquire or the discretion as to his right to acquire, shares to which voting rights are attached, already issued, of an issuer whose shares are admitted to trading on a regulated market"; or, (b)[if the financial instruments] are not included in the above but which are referenced to shares referred to in (a) and with economic effect similar to that of the financial instruments referred to [above], whether or not they confer a right to a physical settlement".

[4] This is, where the issuer represents 20 per cent or more of the index/basket or the long position arising under the index/basket in relation to the individual issuer represents 1 per cent or more of the issued voting shares of the issuer.

Sanctions

TD2 requires that EU member states have “effective, proportionate and dissuasive” sanctions in place for the breach of the rules under TD2, including certain sanctions that all member states are required to put in place.

The FCA will have the power to impose the following sanctions specifically for a breach of the major shareholdings notification rules (and the issuer disclosure requirements):

- an order requiring the person responsible to cease the conduct constituting the breach and to desist from any repetition of that conduct
- a fine of the higher of up to €10m/five per cent of annual turnover; and up to twice the profits gained, or losses avoided, because of the breach (with respect to a legal entity); and up to €2m/twice the amount of the profits gained, or losses avoided, because of the breach (with respect to an individual
- and/or a public statement indicating the person responsible and the nature of the breach. It is expected that the FCA will publish notices of breaches under the DTRs, where appropriate.

In addition, specifically with respect to the breaches of the Disclosure Obligation, the FCA will have the power to apply to the court for an order to suspend the voting rights. Such right shall only be exercised for the most serious breaches. In considering the seriousness of the breach, the Court may take into account whether the contravention was deliberate or repeated, whether the person holding the votes ignored warnings or requests for compliance from the FCA, the size of the holding, and the impact of the contravention on the integrity of the UK. financial system and on any company merger or takeover.

This will represent a significant change in approach for the FCA which has not historically sought to impose particularly severe sanctions for DTR breaches.

Extension of The Investment Manager Exemption

Under the existing rules, investment managers established and regulated in the EEA and in the United States are able to benefit from an exemption, limiting their reporting obligations pursuant to the Disclosure Obligation. Under the exemption, investment managers are only required to submit disclosure notifications of holdings if such holdings meet a threshold of five per cent, 10 per cent or higher, rather than the otherwise applicable disclosure thresholds of three per cent and above, at one per cent increments.

In order to ensure a level playing field across the industry, the FCA proposes to extend the exemption to all investment managers, regardless of the jurisdiction they are established in, provided that their activities are such as to require FCA approval if they were carried on in the UK.

Other Provisions

TD2 also introduces certain other modifications to the disclosure obligations under the DTR, notably:

- the requirement to publish interim management statements will be abolished

- a new requirement applicable to EU-listed and large unlisted EU-incorporated companies that are involved in the extractive industries or in the logging of primary forests to disclose payments of EUR 100,000 or more made to governments. Such disclosure obligations will apply both a country and project basis. This disclosure requirement will have significant commercial, political, legal and administrative consequences for companies operating in such sectors.

The FCA has already implemented these provisions and the DTRs as currently in place reflect the same.

Next Steps

Investment managers who engage in transactions that are subject to the revised scope of the Disclosure Obligation should regularly check that their transparency systems and controls are able to capture and report the data required.

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