Response to FSA Consultation on Disclosure of Contracts for Differences

Introduction

Hermes is one of the largest pension fund managers in the City of London and is wholly owned by the BT Pension Scheme. We also respond to consultations such as this one on behalf of many other clients, including among others the Ireland's National Pension Reserve Fund and Denmark's PKA. We have some £35 billion assets under management and over £45 billion assets under advice.*

Hermes takes a close interest in matters of company law and regulation because they set the context for the exercise of our clients' rights as part-owners of the companies in which they invest. We seek to safeguard our clients' current rights and also to enhance the transparency and accountability of companies and their directors to their long-term owners.

By enhancing accountability, we hope to improve efficiency by addressing what economists call the agency problem. It is our fundamental belief that companies with concerned and involved shareholders are more likely to achieve superior long-term returns than those without. By helping make company directors accountable to company owners for the decisions they make and the actions that they take, we believe that over time we will encourage better decision-making and greater value-creation. We believe that this will benefit our clients, which need long-term real growth to meet their obligations to pension beneficiaries, and it will also make companies and economies as a whole more efficient.

In pursuit of these aims Hermes supports a flexible regime which will:

- encourage company accountability;
- encourage responsible ownership by shareholders and fiduciaries;
- ensure independence of those who audit and monitor company performance; and
- ensure the measures used in reporting performance are relevant for owners.

Markets are only efficient if they enjoy the benefit of transparency and equality of information. We believe that the current markets fail to exhibit these characteristics because of the opacity of CfD and other derivative positions. Companies can feel ambushed in the current environment, and so are other shareholders. We fear that this situation risks bringing the market into disrepute and therefore welcome the FSA's proposal to address this issue. Of the proposals for change, we favour Option 3 because we fear that Option 2 offers loopholes which might be exploited. We do not accept that the FSA's estimation of the cost differential between Options 2 and 3 is accurate or well-founded; we believe Option 2's benefits are more limited than Option 3 as it risks failing to solve the problem. Indeed, we believe that active consideration should be given to going further than the current Option 3 proposal, as described below.

** figures as at December 31st 2007*

Summary

In principle we agree with the FSA's position that the current system does not adequately address the concerns over adequate disclosure and that this lack of transparency can allow CfD holders to have significant influence on companies' corporate governance and / or voting rights. We have heard concerns from many companies about the negative effects of the opacity surrounding CfDs, including large shareholders appearing on registers overnight and funds claiming to hold CfD positions and seeking to influence strategy. Other shareholders – and the market as a whole – are also adversely affected by such events. We, therefore strongly, agree that Option 1, leaving the current regime unchanged, is not appropriate

Although Option 2 has some attractions we have some concerns about its aptness. Specifically Scenario 1 as set out in table 5 on page 56 of the consultation does not appear sufficiently robust to negate the risk of inappropriate manipulation, notwithstanding the existing disciplinary arrangements referred to.

In light of this we consider Option 3, involving the introduction of a comprehensive disclosure regime, is more appropriate to address our concerns.

It should be clear from the above that we welcome the FSA applying attention to the area of CfDs. We would again note, however, that there is a further area where legal and beneficial ownership of shares becomes separated and voting control can on occasion rest in hands where it is not wholly transparent.

This is not in the interests of certainty for companies, transparency nor market integrity. This area is stocklending and we again request the FSA to apply its mind to the regulation of this area so that market confidence can be maintained.

Our answers to the questions posed by the FSA are below.

Question 1: Do you agree that we have identified the concerns of issuers and market participants correctly?

Question 2: Do you agree that we have identified the right market failures? If not, what other potential market failures do you think we should consider?

> Yes, it appears that the major concerns and market failures have been suitably identified.

Question 3: Do you agree with our analysis of the evidence set out in this chapter? Is there further evidence that you think we should consider?

> Yes, we agree and we believe the appropriate evidence has been considered.

Question 4: Do you agree with our conclusion that action should be taken to increase disclosure of CfDs?

> Yes. We are strongly of the view that the current regime is unsustainable, risks bringing the market into disrepute and is also damaging to companies. We believe that more transparency is needed

Question 5: 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?

> We are supportive of the proposed language, though we are conscious that derivative markets evolve rapidly. We would therefore expect the FSA to maintain a high degree of vigilance to ensure that any new instrument of like effect can rapidly be brought under the regime.

Question 6: Do you agree that CfDs not complying with a safe harbour should be disclosed?

Question 7: Do you agree with the specific conditions we have proposed for the safe harbour, and that, as necessary, they can practicably be incorporated into agreements between the parties to a CfD contract?

Question 8: Do you agree that there should be a 'notification to issuer on reasonable request' provision?

Question 9: 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?

Question 10: Do you agree with our proposed approach to aggregation and thresholds for Option 2?

We are not supportive of Option 2. While the introduction of a safe harbour may seem attractive, we fear that it will open the door to abuse by investors which wish to avoid disclosure. We can easily imagine circumstances where an investor falls within the safe harbour at one point but then – almost overnight and through its own actions – no longer does so. We do not believe that companies and the market would feel any less ambushed in such circumstances.

Question 11: Do you agree with our proposed approach to aggregation and thresholds for Option 3?

We support Option 3. However, we believe active consideration should be given to requiring the aggregation of voting rights with CfD positions such that the complete picture is captured in reporting, and to reducing the threshold for disclosure of such aggregated positions to the 3% level. We believe that such steps would ensure that the regime is closer to the current system for disclosure under the Transparency Directive and would be more consistent with developments in other markets around the world.

Question 12: Do you agree with our analysis of the relative costs and benefits of Option 2 and Option 3?

No. We do not believe that the costs work has been done appropriately. As we note above, we fear that Option 2 will not solve the problem so its benefits may well be very limited. Annex 1 on more than one occasion refers to the cost of Option 2 as being minimal. For Option 3 reference is made to 'up-front' costs between £20m and £50m, ongoing costs between £6m and £7.5m and then indirect costs are not quantified. We feel that this contrast between the expected costs of the Options is hard objectively to justify and we believe that the FSA will be on weak ground if it progresses with Option 2 on the basis of such an ill-prepared CBA.

Question 13: Which do you think would best address the identified market failures?

Option 3 - given our expressed concerns over Option 2 and the need for an adequate disclosure regime.

Question 14: Do you agree with our view on what information should be disclosed to the issuer, and how that information should be disseminated?

We are supportive of the proposed disclosure processes.

Question 15: Do you agree with our proposal that we should seek to avoid as far as possible duplication of disclosure?

Yes.

Question 16: 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.