REVIEW OF DFSA MARKETS BRIEF NO 6: ONGOING MARKET DISCLOSURE

FINANCIAL SERVICES REGULATION

Introduction

The Dubai Financial Services Authority ("**DFSA**") is the independent regulator of all financial and ancillary services conducted through the Dubai International Financial Centre ("**DIFC**"). In January 2014 the DFSA published Markets Brief No. 6 ("**MB6**") which discussed the DFSA's policy on:

1. ongoing market disclosure requirements in relation to dividends and other distributions by Reporting Entities; and
2. Connected Persons' disclosures.

The DFSA's Markets Briefs provide guidance about the DFSA's approach and processes for the regulation of DFSA capital markets. The guidance, whilst not formally binding, provides valuable insight into the Regulator's current thinking and concerns. A full consideration of the policies discussed in MB6 is therefore likely to offer its own, regulatory, dividends.

In this paper, we review the regulations and rationale of each of the policies discussed in MB6, explaining why, from a legal and economic perspective, compliance is important. We also examine some wider issues related to these policies, with reference to problems experienced in other jurisdictions.

We find that the policies are a necessary element of a regulatory framework for a fair, transparent and efficient financial services centre, which global investors are prepared to trust. That trust is essential to attract, maintain and grow international investment. These policies therefore provide the DIFC with the platform to cement its position as the regional nexus for global capital flows, and develop into a financial centre as systemically important to the globalized economy as those found in the East and West.

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Periodic distributions

The regulations

A Reporting Entity's market disclosure obligations are set out in Chapter 4 of the DFSA's Markets Rules ("**MKT**") and supplemented by Appendix 2 of that Chapter. For the most part, Chapter 4 deals with obligations and exceptions relating to the disclosure of Inside Information and the interests of Connected Persons. However, MKT 4.6.1 also makes it clear that the matters specified in Appendix 2 must be disclosed to the market regardless of whether they might also constitute Inside Information. It is in Appendix 2 that the specific wording around distributions explored in MB6 is found, with the requirement to disclose *"[a]ny decision… to declare, recommend or pay any dividend or to make any other distribution on the Securities".*

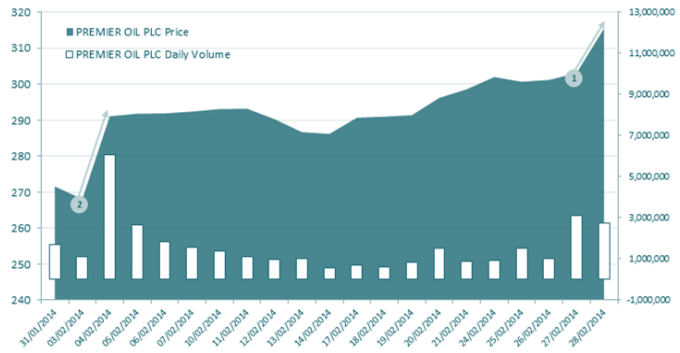
The rationale

In the case of shares, it is relatively simple to demonstrate why certain corporate acts, including the decision to recommend or pay a dividend, give rise to Inside Information which should be made public. Theoretically, the price of a share at any one time reflects the market's expectation of the present value of all future dividends to be issued in connection with that share.[1]

Thus, a dividend announcement contrary to market expectations can – before the effective payment[2] - significantly impact a share price, as well as that of related instruments. This is because it influences investors' short-term and long-term assessments of the extent to which a company will add value to the capital invested in it.

A recent example, drawn from the London Stock Exchange, is the impact of Premier Oil's announcement on 27 February 2014 that it would seek shareholder approval to pay a net dividend of 5 pence per share, compared to the 0.6 pence predicted by analysts. As shown below, Premier Oil's share price increased by 4.38% between the 27th and the 28th (numbered dot "1" in Figure 1 below). [3]

Figure 1: Impact of corporate events on Premier Oil's stock



In this case, with hindsight, we can easily demonstrate that the dividend decision had a "significant effect" on the share price. Between the decision to propose the dividend and the public announcement, knowledge of the proposed dividend was Inside Information. In real-time, one can never be certain of the effect that information will have on market expectations. Nevertheless, applying such prior knowledge to seek to earn profits (or avoid losses), is "insider dealing", no matter the outcome, where a "reasonable investor" would have been likely to use that knowledge as part of the basis of his investment decisions.

Figure 1 also demonstrates that other corporate decisions can significantly impact share prices, and constitute Inside Information before publication. Numbered dot "2" shows that on 4 February 2013 Premier Oil's stock rose 8.58% upon the announcement that the CEO, Simon Lockett, would be standing down. According to a senior Deutsche Bank analyst, *"[b]y stepping down now, Premier has potentially avoided a repeat of last year's AGM where registered votes against key resolutions suggest a lack of investor support."*[4] As shown in Figure 1 the abnormally high volumes traded on 4 February (4.5 times higher than the previous day) confirms that demand (and, by inference, investors' support) for this stock increased.

MB6 also refers to disclosures in respect of debentures, particularly where there is discretion in the calculation of the coupon, or if the rate calculation is based on a variable or floating rate.

In our experience most common debentures do not embed discretionary features in the calculation of a coupon. The interest-rate-methodologies of many benchmark rates referenced in debentures are well-defined, being governed by International Swaps and Derivatives Association, Inc. (**"ISDA"**) agreements. In principle this leaves no discretion for the calculation of a coupon, so long as the timing of the calculation and the rate to be applied is clear.[5] We reviewed a sample of bond prospectuses approved by the DFSA. Most of these referenced ISDA definitions and are generally standard in this respect.

Where there is no discretion in the calculation of a coupon but there is a variable element, due to the

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1 This is why, where a dividend is consistent with market expectations, an 'ex-dividend' share price is lower than a "cum-dividend" share price. In many markets for tax reasons the decrease is usually less than the amount of the dividend.

2 The ex-dividend date is the date after which the seller, and not the buyer, of a stock is entitled to a recently announced dividend.

3 The movement corresponded with the announcement by the company of its decision to recommend the dividend, as opposed to the date on which shareholders would become entitled to the dividend.

4 Lucas Hermann, quoted in the article "Premier Oil Jumps in London Trading After CEO Lockett Steps down", published by Bloomberg on 4 February 2014.

5 There may be third party discretion in rare instances where the publication of a rate is discontinued. This was the case with certain LIBOR currencies and maturities (see "LIBOR Currency/Maturities Discontinuations – Guidance Note" published by ISDA on 25 March 2013).

presence of a variable or floating rate, the potential for Inside Information is limited. Nevertheless, MB6 is clear that, whilst predictable, the act of fixing the variable or floating rate at the required time and the calculation of the actual payment resulting from that fix, is still considered to amount to a "decision" and to therefore trigger a market disclosure obligation.

Whilst coupon calculations for vanilla bonds generally do not involve discretion, this may not be the case for hybrid debentures, particularly Tier 1 capital securities with equity / option features, such as perpetual bonds. Some DFSA approved prospectuses are for debentures with hybrid features. These debentures do present the potential for Inside Information, particularly when the option is to the issuer. For example, the price of a callable perpetual bond will be sensitive to the issuer's decision of whether or not it intends to redeem the bond on any given future call date.[6]

Even with vanilla bonds, there can be a series of intricate caveats within a prospectus, giving the issuer the right to withhold distributions in certain circumstances. Viewed in this light, the obligation to disclose the calculation of what appears to be a predictable distribution, can also be seen as an obligation, with a set minimum timing, to give an implied confirmation that such circumstances have not occurred. It is not difficult to predict how such an implied confirmation could become influential to trading decisions, particularly where rumours to the contrary are in circulation.

Comment

The ramifications of insider trading can be extensive. From a quantum perspective, purchasing or disposing of shares before the announcement of a dividend decision or other corporate acts could be an isolated action, with negligible market-wide impact. In this case, ill-gotten profits (or losses avoided) may be calculated with relative certainty, on the basis of objective evidence and hard data.

However, in some cases we have seen, insider trading also causes market disruption. Here, to model the counterfactual scenario ("but-for" the alleged wrongdoing) a proper quantum assessment involves assessing the market impact of any misconduct, while simulatenously stripping out the effects of general market movements and other factors. This can require elaborate market-data manipulations as well as sophisticated mathematical modelling. At its most complex, therefore, quantifying the effects of insider trading can be challenging.

Casting an eye to other financial markets, guarding against the abuse of material non-public information is an issue that has increasingly demanded the attentions of financial markets regulators, compliance officers and general counsel in recent years.[7]

For entities regulated by DFSA, MB6 provides clarity over some of the regular business decisions which must be disclosed, regardless of whether they also constitute Inside Information in their own right.

Such obligations are appropriate to ensure a fair and transparent market and bring a degree of standardisation, particularly as regards timing of disclosures, where inconsistent approaches might otherwise be observed.

Reporting Entities should have careful regard to this policy requirement and ensure that their existing systems and controls are sufficient to ensure compliance.

The question of whether systems and controls are sufficient is never a simple one, however. To once again take the example of a vanilla bond with intricate caveats that could justify the issuer withholding distributions, it is easy to foresee complex systems and controls issues arising. Assume, for example, that the wording of the caveats in the prospectus provide that a distribution will not be made if certain circumstances exist. In that case, the issuer would be required to consider whether those circumstances are being adequately monitored, so that payment of a distribution will not risk creating a misleading impression in the market. That serves as just one illustration of the degree of care needed in assessing the adequacy of systems and controls in this context.

[6] This decision could also impact the share price, depending on the company's circumstances and ability to raise additional capital.

[7] See, for example, Market Watch 44 published in August 2013 by the UK financial regulator the Financial Conduct Authority (FCA), which explains that over the past 18 months the FCA has increased its focus on suspicious transaction reports.

Connected Persons

The regulations

There are two distinct types of Connected Person defined in MKT 4.3.2. The first is a Connected Person by virtue of being a Director or senior manager of the Reporting Entity (or of a controller of the Reporting Entity[8]). The second is a Connected Person by virtue of owning or controlling voting Securities carrying more than 5% of the voting rights in the Reporting Entity (or in a controller of the Reporting Entity).

That distinction is important, as MKT 4.3.3 sets out different disclosure obligations for each type of Connected Person as regards their investments. A holder of more than 5% of voting rights must disclose the fact of meeting or falling below that threshold, along with every increase or decrease of 1% or more in those voting rights.

A Director or senior manager, however, must disclose the fact they have acquired, or ceased to hold, *"any Securities or other Investments in or relating to the Reporting Entity or a controller of the Reporting Entity",* as well as any subsequent increase or decrease of at least 1% in that level of interest. That is a more onerous obligation, as it requires the disclosure of purely economic interests held in the form of derivatives or non-voting Securities.

It is, of course, entirely possible to fall within both definitions, in which case the more onerous obligations will apply.

The rationale

The trigger events identified in MB6 permit the regulator and other market participants to monitor Connected Persons' trading patterns. Not only does that help to create a level playing field in terms of the current sentiment of influential investors, but it assists the regulator to identify, deter or prevent, among other things: trading decisions driven by Inside Information; potential market manipulation, particularly in the case of large stakes; and secret stake-building. The policies ensure transparency in the case of takeovers, mergers and acquisitions in the period before the separate thresholds in the Takeover Rules Module of the DFSA's Rules are reached.

For Connected Persons who hold a senior management position in a company, transactions in both Securities and other Investments must be disclosed. This helps to guard against those with Inside Information earning secret profits by trading based on that information, whether trading in shares or in derivative instruments. More subtly, it also helps to avoid a failure to recognise, as Inside Information, the confidence (or lack of confidence) in a Reporting Entity's future performance that a senior manager's purely economic dealings can indicate.

Where a person is connected by holding at least 5% in voting rights in an entity, the disclosures address secret stake building. They can also address the disclosure of potential Inside Information where, for example, someone who is known as an influential shareholder activist begins to acquire a significant stake in a Reporting Entity. However, only transactions which involve the purchase or sale of voting rights must be disclosed. This does not, for example, cover cash-settled derivatives which do not carry voting rights or result in an entitlement to acquire shares. Connected Persons may still thus build indirect stakes which have the potential to influence the market, as the banks that underwrite these instruments may elect to hedge their exposure by holding actual shares, taking these shares out of general circulation.

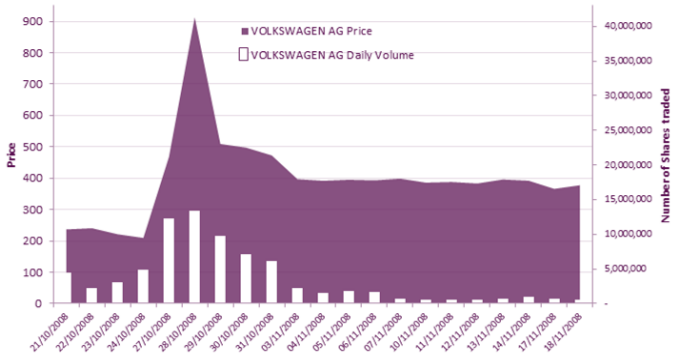
That was the case when Porsche's investment activity relating to Volkswagen in 2008 had a remarkable effect on the relevant markets. Porsche announced its intention to build its stake in VW to up to 50%, and extended its direct shareholding from 35% to 42.6%. At the same time it announced having boosted its market exposure by a further 31.5% via the use of cash settled options. Under German regulations the indirect investment did not need to be disclosed, yet in reality physical shares were purchased by the underwriting banks. The consequence was one of the greatest "short squeezes" in history, which briefly made Volkswagen the world's most valuable company.

A number of investors, mostly hedge funds, had taken short positions on Volkswagen, borrowing and selling its stocks in the hope they would be able to buy them back at a reduced price in the near future. Once Porsche announced the existence of its cash

[8] The definition of a controller is set out in MKT 4.3.2(a) and is concerned with majority control of the voting rights or the right to appoint or remove the majority of the board.

settled options, it became obvious that only 6% of Volkswagen's issued shares were still potentially liquid, when short sellers had obligations to replace borrowed shareholdings estimated at 12% of those shares. Simple rules of supply and demand then took effect and, in the resulting panic of investors trying to close their positions, the share value rocketed. We refer to Figure 2.

Figure 2: Impact of Porsche's trading onto Volkswagen, October 2008



Comment

It is worth emphasizing that the introduction to this topic in MB6 states that the DFSA has recently seen a number of issues that cause it to have concerns about compliance with the disclosure rules for Connected Persons. That is a relatively strong statement which may well indicate that enforcement action will follow if a general improvement in compliance with those Rules is not forthcoming.

The dealings of Connected Persons can be a powerful barometer of sentiment in those closest to a Reporting Entity's business. It is obviously desirable for market confidence that the wider market and less closely connected investors are given access to that barometer. A failure by a Connected Person to make adequate disclosures to a Reporting Entity can also lead to inaccuracies and misleading statements being released to the market.

The GBP 210,000 fine levied on Sir Ken Morrison by the UK's regulator in 2011 is a good example of why individual investors, as well as Reporting Entities, must be aware of these obligations and the potential consequences of a failure to meet them[9]. In that example, the regulator seemed to accept that Sir Ken was simply not aware of the requirement to make disclosures when his shareholdings fell below relevant % thresholds, but was clear that he should have been. The consideration of the seriousness of his failures (and, consequently, the level of the fine imposed) was influenced by the fact that those failures led to the Reporting Entity in question publishing an inaccurate statement regarding his shareholding in its annual report.

The dangers posed by leakage or market abuse prior to takeovers, mergers and acquisitions, further justify the need for the disclosures explained in the DFSA's brief.

More widely, it is fair to say that the absence of disclosure rules for derivative investments has provoked some discussion in recent years.

There is an obvious potential for large volumes of derivatives to become a tool for market manipulation.

In February 2011, for example, Deutsche Bank AG was heavily penalised for manipulating the KOSPI market by physically settling large volumes of derivatives contracts during the trading close auction. This was the result of closing a systemically important index arbitrage trading position. Korean prosecutors alleged that, on 11 November 2010, KOSPI 200 futures and options traders earned more than 45bn won (USD 41.5m) in unfair index arbitrage trading. Seoul's benchmark share index fell by 48 points, or 2.7%, in the last 10 minutes of trading in that day. Subsequently, regulators limited the number of equity derivative contracts investors are permitted to hold and put in place new disclosure rules.

We also refer to the very large indirect stake built up in Anglo Irish Bank Corporation by Mr Sean Quinn between 2006 and 2008. Mr Quinn's investment was built up through contracts for difference (**"CFDs"**). CFDs are tradable, cash-settled instruments that mirror price movements of an underlying asset, but do not entail ownership. Banks who sold the CFDs had, however, hedged their exposure to Mr Quinn by physically purchasing Anglo Irish shares. Ultimately, Anglo Irish itself provided funds to purchase shares as Mr Quinn's position was unwound. These transactions are the subject of ongoing criminal proceedings in Ireland.

[9] "Final Notice" issued by the Financial Services Authority to Sir Ken Morrison, 16 August 2011.

On the other side of the discussion on disclosure of derivatives, however, there is an obvious desire for investors, particularly successful investors, to be able to protect the details of their trading strategy in circumstances where their investments do not represent the ability to influence the relevant issuer's performance or strategy through voting rights.

Ultimately the Rules and the enforcement of the Rules must strike a difficult balance between maintaining stability, transparency and investor confidence, whilst providing an environment which attracts companies and investors (who sometimes value privacy, for legitimate reasons).

In this regard, the DFSA Rules do not seem to us to be particularly more onerous than rules in other jurisdictions, having been largely based on the UK's implementation of the EU's Market Abuse Directive.

The absence of disclosure rules specific to derivatives is balanced by restrictions on market manipulation and a requirement for authorised firms to report suspicious transactions.

This is consistent with the DFSA's risk-based regulatory approach; avoiding an unnecessary compliance burden in what is still a relatively small, although quickly developing, market. It is also consistent with the DFSA's desire to give investors confidence, by incorporating standards that reflect international best practice.

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Herbert Smith Freehills is a leading global law firm with over 20 offices across Asia Pacific, the UK, Europe, the Middle East and US. The firm's market leading regulatory practice delivers a seamless global service, providing clients with practical and commercial advice about the impact of regulation on their business and their dealings with regulators.

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