

MIFID targets Contracts for Difference

CFDs have featured centrally in the drama of the Irish equity market over the past year, and have been a source of leverage at a time of heightened volatility, with predictable results. Now MIFID will have implications for the sale and execution of CFDs. Paul Foley analyses.

Investors will be aware that November 1st 2007, marked the date on which the infamous new EU regulatory regime for investment services, stock exchanges and alternative trading facilities took effect. The regime represented by two complex directives and a regulation, the Markets in Financial Instruments Directive (MiFID).

MiFID allows banks and other investment institutions to compete fairly with stock exchanges as trading venues. This in turn, gives investors access to a greater number of trading venues both in Ireland and in other EU member states, in order to buy and sell a range of financial instruments.

One of the common misconceptions about MIFID is that its comprehensive investor protection regime only applies when investment services are sold to an investor on quoted equities. In fact, the majority of the obligations imposed on investment firms by MiFID apply not just to quoted equities but to a wide range of financial instruments which are negotiable on the capital markets, including many derivative products.

CFDs

One particular category of derivative that is attracting a lot of concern, is contracts for differences sold on quoted equities (CFDs). A CFD on a share is a derivative product that gives the holder an economic exposure which can be a long position (the holder gains from a rise in the underlying share price) or a short position (the holder gains from a drop in the underlying share price). The product generally gives the holder no right to acquire the underlying shares. Contracts are normally open-ended and can be closed out by the CFD holder on demand. CFDs with three to six months maturity are the most widely used.

The use of CFDs by investors has grown exponentially in the last five years. Current estimates suggest that 30 per cent of equity trades in the UK are in some way driven by CFD transactions.

The reasons for investors trading in CFDs rather than buying the underlying shares are many, including leverage, the investor is required to provide only initial collateral at between 5-10 per

cent (however the collateral required in Ireland tends to be much higher) of the nominal value of the underlying share when the contract is opened, ability to go short, avoidance of stamp duty, greater market opportunities (the investor can gain exposure at a relatively low cost to a very wide range of stocks, market indices, currencies and other assets) and maintaining anonymity.

In addition, the evolution of the Internet and electronic trading platforms has reduced transaction costs involved in undertaking CFD transactions.

CFDs and MIFID

From the investment firms' perspective, it is important to note that most CFDs are financial instruments within MIFID and therefore if the investor is offered a CFD as part of an investment advice package or as part of a portfolio management service, then the CFD can only be offered if the product is suitable for the investor.

Suitability requires the investment firm to obtain enough information from the investor to have a reasonable basis for believing that the specific transaction to be recommended or entered into (as part of a portfolio management service) satisfies the investment objectives of the client and does not expose the client to risk of a kind he/she is not able to bear financially or understand. If the firm does not obtain enough information from the investor to determine suitability, then the firm must not recommend the financial instrument to the investor.

Where any other investment service is provided on a CFD (a complex product for regulatory purposes), then the investment firm must obtain information regarding the investor's knowledge and experience of CFDs and make a determination of appropriateness. If on the basis of the information received, the product is not appropriate then the (potential) client must be warned. The suitability and appropriateness tests can only be avoided in limited circumstances, essentially where at the initiative of the client, execution and/or the reception

and transmission of client orders on non complex financial instruments is provided.

Best execution

The other common misconception about MIFID, is that the obligation on investment firms when executing orders on behalf of a client, to obtain best execution only applies when executing orders for shares listed on recognised stock exchanges. Again this is incorrect, as the best execution requirement applies to many derivative products, whether quoted are not, so long as they are a financial instrument within MiFID. However where the investor shops around and asks for quotes from several dealers (such as in the wholesale over the counter (OTC) derivatives markets), the requirement for the investment firm to provide best execution, where his quote is accepted, will depend on the extent to which the investor legitimately relies on the firm to protect his or her interests.

Best execution is the obligation when acting on behalf of a client, to take all reasonable steps to obtain the best possible result for the execution of the client orders, having due regard to the wider market in any relevant instrument. The execution process has to be reflected in an execution policy, which must specify the execution venues and, where derivatives are involved, must address and distinguish between exchange traded derivatives and OTC products. The client has to consent to the execution policy.

One of the more onerous part of the best execution regime is the requirement that the investment firm demonstrate if required, to the investor that his orders have been executed according to the firm's execution policy. Best execution and the related record keeping obligations constitute major challenges for investment firms.

While achieving best execution in the case of equities is aided by the pre-trade transparency obligations imposed on firms which are systematic internalisers in liquid shares and post-trade disclosure obligations imposed on investment firms and stock exchanges by MiFID, achieving best execution for derivatives such as CFDs which are

executed OTC, will be a much more difficult proposition, as in many cases benchmarks particularly on pricing may not be available.

Specific concerns with CFDs

Why the concern with CFDs? There are a number of concerns expressed by issuers and investors including:

- That the lack of transparency with respect to substantial economic interests obtained through CFDs, allows the use of those interests as a means of exerting influence over, or to gain control of the voting rights attaching to the underlying shares
- That issuers are unable to know who has significant economic exposure to their shares and the scope that provides for potential abuse
- That hedge funds may outflank traditional institutional investors by using economic interests obtained through CFDs to influence companies and that some investors may be disadvantaged by investing in a market where others may have better information.

While the Transparency Directive requires disclosure of a direct or indirect control of voting rights attached to shares above a 3 per cent threshold (5 per cent in Ireland), including where a

person is entitled to acquire voting rights as a result of holding certain financial instruments, if the CFD is cash settled and does not confer voting rights there is currently no disclosure requirement under the Transparency Directive.

The UK Takeover Code does require disclosure of pure economic interest in shares. Once a company is an offer period, a person with a direct or indirect interest in 1 per cent or more of any class of relevant security must publicly disclose all dealings in the company's securities. To reach the 1 per cent holding, call options and long derivative positions are aggregated. The situation is somewhat different in Ireland, where the disclosure obligation is driven by ownership or control of at least 1 per cent of the shares, in which case all interests have to be disclosed including economic interests held through derivatives.

Lastly the company law regime in both countries entitling a public company to find out who has interests in its shares and the disclosure requirements of shareholders to the company of their holdings above certain percentage levels are not considered to apply to interests held through CFDs.

Following on from a survey procured by the FSA of the practices of banks and market participants with regard to

CFDs, the FSA has concluded that CFDs are sometimes being used firstly to seek to influence votes and other corporate governance matters on an undisclosed basis and secondly to build up stakes in companies again without disclosure.

It has therefore decided that it should take action now to address these failures and is currently consulting on a number of approaches with a view to require the disclosure of substantial economic interests in shares held through derivatives such as CFDs. The first approach would deem CFDs to have access to voting rights and therefore would require disclosure above a 3 per cent threshold, unless stringent safe harbour requirements are met (including that the agreement with the CFD holder specifically precludes the holder from exercising or seeking to exercise voting rights). The second approach would require disclosure of all economic interests above a 5 per cent threshold (a general disclosure regime). The consultation closed on February 12th 2008. Whether the initiative taken by the FSA will be followed by other Member State regulators remains to be seen.

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Regulatory issues and alternatives: the importance of MIFID

The Markets in Financial Instruments Directive (MiFID) applies to investment firms and credit institutions when providing investment services and to regulated markets. MiFID is a comprehensive regulatory regime covering investment services and financial markets in Europe and introduces common standards for investor protection throughout the European Union. The MiFID Regulations were transposed into Irish law on 15 February 2007 and came into effect on 1 November 2007.

Hedge Funds investment - is unregulated, and as such, falls outside of the auspices of the Financial Regulator in Ireland. Any investment in a hedge fund by a private investor is likely to be substantial. Given that private investors in hedge funds are dealing in such large amounts, it is presumed that they are sophisticated investors aware of the risks and rewards involved. This is similar to the qualifying investor fund (QIF) in Ireland, where the minimum investment is €250,000, thus excluding retail investors.

However, the Regulator has made provision for retail investors to become involved in the alternative investment sector through the establishment of funds of hedge funds. In its report, 'Enhancement of the EU framework for investment funds - expert group reports: Comments of the Irish Financial Services Regulatory Authority', the Regulator commented on the availability of fund of hedge funds to retail customers, saying, 'we consider that there is scope for the introduction of a harmonised hedge fund product, for sale to retail investors, in the form of a fund of hedge funds.'

Private equity - The premier funds are often accessible only to investors able to make commitments of €10 million in each fund, so creating a diversified portfolio of around ten private equity funds would require a commitment of around €100 million. Instead, investors need to focus on getting diversified exposure to the best performing managers. For most investors, the most effective solution will be to use a fund of funds, a vehicle

whose popularity has grown rapidly, particularly during the last five years. The wide variation in private equity returns between top quartile and median managers is the main driver for investors to use a fund of funds in order to get diversified exposure to the top performing funds.

Qualifying Investor Funds (QIFs) can, accordingly, pursue investment strategies which include short selling, significant borrowings, derivatives and investments in hedge funds, without restriction. Similarly, the limits on the level of investment in any given market or securities which apply to all other types of funds in Ireland do not apply to QIFs.

Accordingly, QIFs are particularly suitable for sale to sophisticated and experienced investors, who are expected to be aware of the risks of more aggressive investment strategies. In order to qualify as a QIF, the fund may only accept investors who satisfy certain eligibility criteria (Qualifying Investors) and who subscribe a minimum of €250,000 into the fund.