THE TAKEOVER PANEL

CODE COMMITTEE

DERIVATIVES AND OPTIONS REGIME: 2007 REVIEW

1. Summary

During 2005 and 2006, the Code Committee consulted on, and implemented, far-reaching changes to the Takeover Code in relation to derivatives and options. These changes comprised:

(a) new dealing disclosure rules;

(b) new control issues rules; and

(c) the creation of recognised intermediary ("RI") status.

These changes, which are summarised below, are referred to collectively in this statement as the "new regime". In respect of the new dealing disclosure rules, Rule 8.3 disclosures which would have been made irrespective of the changes are referred to as "old regime" disclosures and those which have been made as a result of those changes are referred to as "new regime" disclosures.

The Code Committee undertook to review the operation of the new regime and to publish its conclusions. This statement sets out those conclusions.

In summary, the Code Committee has concluded that the new regime changes as a whole, and the new dealing disclosure rules in particular, have achieved their principal objectives, that they have done so without imposing undue burdens on market participants and, accordingly, that they were a proportionate regulatory response to the increasing use of derivatives during bids. The Code Committee has

therefore concluded that at this stage no amendments to the new regime need to be made. However, as described below, the Code Committee intends to give further thought to certain dealing disclosure issues in due course.

2. Informal consultation

On behalf of the Code Committee, the Panel Executive undertook an informal consultation exercise to establish reactions to the operation of the new regime. Comments were invited from 113 entities, including trade bodies, hedge funds, companies which had been in offer periods, institutional fund managers, corporate finance advisers, corporate brokers, compliance officers, traders and solicitors. These entities were selected for one or more of the following reasons:

(a) the new regime had imposed new obligations on them (e.g. hedge funds which were obliged to make disclosures of dealings in derivatives and compliance officers charged with the task of compliance);

(b) they were potential beneficiaries of the new regime (e.g. investors, companies which had been in offer periods and securities houses with trading desks which enjoyed RI status);

(c) they were involved in advising on takeovers (e.g. corporate finance advisers, corporate brokers and solicitors) or were active market participants (e.g. traders); or

(d) they had expressed opinions on the new regime either at the proposal stage, by responding to the relevant public consultation papers (PCPs 2005/1, 2005/2 and 2005/3), or subsequently, in the context of bid transactions or otherwise.

The overwhelming majority of the 89 respondents commented on the new dealing disclosure rules but few had comments on the new control issues rules or the creation of RI status.

The Code Committee is grateful for the responses it received and which it has considered carefully. Its comments and conclusions are set out below.

3. New dealing disclosure rules

(a) Summary of the changes

On 7 November 2005, Rule 8.3 was amended to provide that long derivative and option interests count in the same way as shareholdings towards the 1% trigger threshold for the disclosure of dealings. A summary of these changes can be found in the section headed "The Code" – "Summary of 7/11/05 changes" on the Panel's website at www.thetakeoverpanel.org.uk.

The new regime also adopted the "composite disclosure model", whereby a person is required to disclose his positions, whether long or short, and whether in physical stock or synthetic, in all classes of relevant securities of the company in respect of which he triggers a dealing disclosure. The objective of the composite disclosure model is to give a "complete picture" of the discloser's positions.

(b) Operation

The Code Committee considers the following points to be of note.

Increase in number of disclosures

The new dealing disclosure rules increased the number of Rule 8.3 disclosures by approximately 19.3% (i.e. new regime disclosures as a percentage of old regime disclosures) over the period from 7 November 2005 to 31 May 2007. This percentage has varied month on month but has demonstrated a general rising trend. The increase for the three month period to 31 May 2007 was 24.7%.

Disclosure complexity

The overwhelming majority of new regime disclosures involve dealings or positions in single stock contracts for differences ("CFDs") and such disclosures are not generally complex or difficult to understand. A very small number of new regime disclosures have resulted from dealings in options and the balance have been disclosures required under the composite disclosure model.

Market liquidity

Whilst it is difficult to measure objectively the impact of the new dealing disclosure rules on market liquidity, the Code Committee has no evidence to suggest that there has been a decline in market liquidity in bid stocks since November 2005. On the basis of comments by traders and other market participants there appears to be no perception that liquidity has suffered.

(c) Consultation responses

Support amongst respondents for the new dealing disclosure rules was strong across all constituencies. 90% of the respondents declared themselves to be in favour of the new disclosure regime and a large proportion of them expressed the view that the new rules have significantly improved market transparency during offer periods. Whilst the new regime has led to a considerable number of additional disclosures, the responses received clearly indicate that the market has had little difficulty in analysing and absorbing these.

A number of respondents made suggestions for amendments to the new rules or for further rule changes which might be made. Their comments and suggestions, and the Code Committee's reactions to them, are summarised below.

Rule 8.3 trigger threshold

Two respondents suggested that the Rule 8.3 trigger threshold for dealing disclosure should be raised to 2%. Another respondent suggested that Rule 8.3 might be

amended to apply only when a person's interests move up or down through a whole percentage point. Other respondents argued that the trigger threshold should remain unchanged or should be reduced.

The outcome of a takeover may be decided by a fine margin and the Code Committee considers that the 1% threshold in Rule 8.3 has stood the test of time since it was introduced in 1987 and that it remains appropriate. It also considers that all dealings should be disclosed by persons with significant interests in relevant securities and not merely those which increase or decrease such persons' interests through a whole percentage point.

The Code Committee has therefore concluded that the Rule 8.3 trigger threshold, and the way in which it operates, should remain unchanged.

Composite disclosure

Two respondents suggested that the composite disclosure model leads to a number of disclosures which, they argued, are of little interest to shareholders. The respondents noted that an interest of 1% in, for example, a class of convertible securities might, on conversion, give the holder an interest of less than 1% in ordinary shares.

The Code Committee recognises that point and it has sympathy for suggestions that would reduce disclosures which can safely be regarded as inconsequential. It intends to give further thought to the subject of composite disclosure in due course.

Disclosure of significant interests at the start of offer periods

18 respondents noted that Rule 8.3 is triggered only when a person with an interest of 1% or more in relevant securities of an offeror or offeree company deals in any relevant securities of that company and that, as a result, if a person has any such interest at the commencement of an offer period which has not been disclosed publicly, then his interest will remain undisclosed if he does not deal during the offer period. Given that one of the main purposes of Rule 8.3 is to assist shareholders in determining where voting control of a company lies, such respondents argued that this

represents an anomaly. Accordingly, they suggested that persons with interests of 1% or more in relevant securities at the commencement of an offer period should be required to disclose their positions at that time. This is referred to in this statement as the "snapshot suggestion".

The Code Committee recognises the logic of the snapshot suggestion. Its adoption would, however, be a significant step because it would extend disclosure obligations to persons who would not have dealt in relevant securities. Accordingly, the Code Committee considers that careful thought should be given to the manner in which such new disclosure obligations might operate and has asked the Executive to analyse the extent and nature of the interests in relevant securities which the adoption of the snapshot suggestion might reveal. The Code Committee will consider the results of this exercise in due course and will then reflect further on the merits of this idea.

Securities borrowing and lending and short selling

Six respondents suggested that securities borrowing and lending transactions should be treated as dealings and, accordingly, should be disclosable. One respondent declared its opposition to this idea.

In addition, 16 respondents suggested that Rule 8.3 dealing disclosure requirements should be extended to persons with significant short positions. Two respondents declared their opposition to this idea.

Securities borrowing and lending and short selling are related subjects. The Code Committee has considered both subjects in the past and intends to reconsider them in due course.

Derivative counterparty disclosure

Five respondents suggested that some form of disclosure requirement should be imposed on the counterparties to derivative positions. They also raised the possibility that persons who disclose derivative positions should be obliged to identify the counterparties to those positions so as to enable shareholders to reconcile disclosures

of derivative positions by hedge funds and other market participants with other disclosures by counterparties. Counterparties to derivative positions are usually securities houses which are likely to enjoy RI status and accordingly to be exempt from the disclosure obligations in Rule 8.3.

The Code Committee does not agree with this suggestion. It believes that the new dealing disclosure rules in their current form provide shareholders with sufficient information in relation to derivative dealings.

Rule 8.3 disclosure deadline

Two respondents suggested that the Rule 8.3 disclosure deadline, being 3.30pm on the business day following the date of a dealing, should be brought forward.

The Code Committee agrees that disclosures will be of more benefit to the market if they are made quickly. However, the previous 12 noon Rule 8.3 disclosure deadline was relaxed to 3.30pm in November 2005 specifically because persons located in different time zones had difficulty in complying with the 12 noon deadline and because it was anticipated that the new dealing disclosure rules might take more time to comply with than the rules which preceded them. The Code Committee does not consider it appropriate to amend the disclosure deadline at this stage but it will keep this issue under review.

Technical suggestions

A number of respondents made suggestions regarding the procedure for making disclosures and the detail of what is required to be disclosed on Disclosure Forms. The implementation of the suggested changes would not require Code amendments. Some of these suggestions have been adopted. Others are being examined by the Executive.

4. New control issues rules

(a) Summary of the changes

On 20 May 2006, the mandatory bid rule (Rule 9) was amended so as to provide that long derivative and option interests should be taken into account in addition to shareholdings. In addition, the restrictions on acquisitions in the 30% to 50% band under Rule 5.1, and the offer price setting provisions of Rules 6, 9.5 and 11, were amended to take account of dealings in derivatives and options.

(b) Operation

A small number of technical issues have arisen under the new control issues rules but these have not caused any material difficulties in the cases concerned.

(c) Consultation responses

Few respondents made comments on the new control issues rules. 15 respondents declared themselves to be in favour of these rules and no significant objections were received.

The Code Committee considers that the adoption of the new control issues rules was sound and that it has achieved its objective without imposing undue burdens or constraints on the market. Accordingly, it has concluded that no changes to these rules should be proposed.

5. Creation of RI status

(a) Summary of the changes

On 20 May 2006, the Code Committee introduced RI status for trading desks whose primary function is client-serving business, and not proprietary business, with the purpose of ensuring that the implementation of the new regime did not deter trading

desks from taking positions in order to satisfy client orders, to the detriment of market liquidity. If a trading desk is granted RI status, the following dispensations apply:

(a) to the extent that the desk has interests in shares in a client-serving capacity as a result of positions in derivatives or options, those interests are not to be taken into account for the purposes of the mandatory bid rule (Rule 9); and

(b) to the extent that the desk deals in relevant securities in a client-serving capacity, it will not be required to disclose those dealings under Rule 8.3.

(b) Operation

An obvious concern in relation to RI status is that proprietary business booked through trading desks which enjoy RI status might be miscategorised as client-serving business and thereby benefit from the above dispensations in a manner not intended by the Code Committee.

The Executive has informed the Code Committee that it is not aware of any instance where a securities house whose trading desks enjoy RI status has had interests in relevant securities, including long derivative or option positions, of a percentage approaching 30%. This provides comfort in respect of Rule 9. The Code Committee also understands that the great majority of significant positions held during offer periods on trading desks which enjoy RI status represent hedges against derivative exposures. The Code Committee considers hedge positions of this kind to be client-serving in nature.

Since May 2006, the Executive's market surveillance unit has undertaken 409 investigations of positions of 1% or more held during offer periods on trading desks which enjoy RI status. In 96.6% of such cases, the net client-serving position, having deducted stock held as a hedge against derivative exposures, was below 1%. The results of those investigations indicate that the risk of disclosure obligations being avoided as a result of dealings and positions being miscategorised is relatively small.

(c) Consultation responses

Few respondents made comments on RI status. 15 respondents declared themselves to be in favour of this status. One respondent expressed scepticism about the client-serving and proprietary business distinction and another requested the publication of an objective set of criteria for making this distinction.

The Code Committee understands the attraction of establishing an objective set of criteria for distinguishing between client-serving and proprietary business. However, it has doubts about whether such a formulaic distinction would in practice assist with the policing of RI status and it believes that the Executive's current approach of making informed judgements on a day-to-day basis has proved to be a workable one.

In the light of the Executive's experience to date and the comments made by respondents, the Code Committee has concluded that RI status should be retained in its current form.

(d) Annual review

In RS 2005/3, the Code Committee expressed an expectation that if RI status were retained, securities houses whose trading desks enjoyed RI status would be subject to an annual review of their RI status and to an annual fee. It believes that it is appropriate to implement an annual review and to require securities houses to pay a charge of £5,000 per annum for each group entity which benefits from RI status. The Executive will discuss these steps with securities houses, with a view to putting them into effect later in the year.

29 June 2007