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ALERT MEMORANDUM

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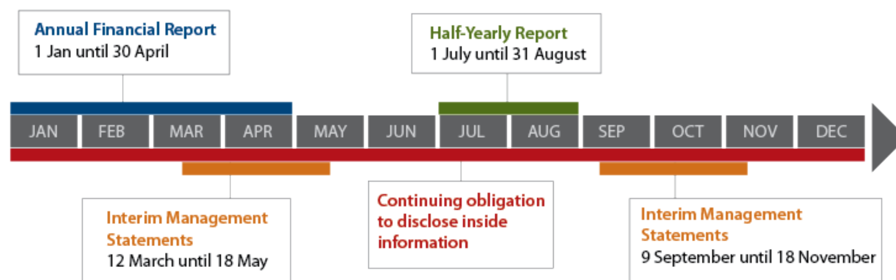
Proposed Amendments to the Transparency Directive

In June 2013, the European Parliament adopted the compromise agreement text[1] of a new Directive amending the Transparency Directive (the "**TD Amending Directive**"). The EU Commission (the "**Commission**") began a review of the Transparency Directive (Directive 2004/109/EC) (the "**TD**") in 2009 and, following an industry consultation, produced a set of proposals for reform in 2011. The amendments are expected to come into effect by mid-2015.

I. KEY CHANGES

- The obligation to publish interim management statements ("**IMSs**") or quarterly financial reports will be removed except where Member States can demonstrate that the administrative burden involved is proportionate.

- The deadline to publish half-yearly financial reports will be extended to three months after the end of the relevant reporting period.



[1] Available at: http://tinyurl.com/TDamendmenttext

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- Measures will be introduced on an EU level to prevent financial instruments being used to achieve "hidden ownership" of shares and "empty voting". Holdings of financial instruments that have the same economic effect as holdings of shares or that give rise to entitlements to acquire shares will become disclosable for the purposes of notifications of major shareholdings. Obligations of this kind already exist in several Member States.

- New disclosure requirements will be imposed on issuers in extractive or logging industries for payments made to the governments of the countries in which they operate.

- Certain other changes aimed at harmonising liability for breaches of TD rules and as regards format and availability of reports will also be introduced.

II. DISCUSSION

1. Interim Management Statements

Background

Opponents of IMS and quarterly reports have argued that such reports are not necessary for investor protection, that they create unnecessary administrative burdens (especially on small and medium sized issuers) and that they encourage 'short-termism' and unreliable financial reporting. One of the key recommendations of the 2012 Kay Review of U.K. Equity Markets and Long-Term Decision Making[2] (the "Kay Review"), for example, was that mandatory IMS obligations should be removed and succinct narrative reporting should be strongly encouraged. The Kay Review characterised interim reporting as 'information overload', distracting and confusing for both investors and businesses rushing to produce the necessary disclosure.

Notably, the EU transparency regime, by virtue of the Market Abuse Directive (Directive 2003/6/EC), already imposes an overarching obligation on listed companies to disclose inside information as soon as possible, thereby alleviating the reliance on periodic financial reports for disclosure of potentially material information. By contrast, the U.S. periodic reporting regime requires U.S. domestic issuers to file (i) quarterly reports on Form 10-Q, containing principally financial statements and MD&A, and (ii) Current Reports on Form 8-K only upon the occurrence of certain specified events, such as entry into or termination of a material definitive agreement, completion of an acquisition or disposition of assets or creation of a direct financial obligation or off-balance sheet arrangement[3]. In the absence of any requirement under the U.S. rules to update the market continuously, these periodic reports represent an important source of price-sensitive information about U.S. public companies that is likely to be disclosed on a more

[2] Available at: http://tinyurl.com/KayReview2012

[3] The 8-K list of information to be disclosed on an on-going basis by U.S. domestic issuers is available at: http://www.sec.gov/about/forms/form8-k.pdf

immediate basis for companies subject to the EU transparency regime. The EU obligation to disclose inside information as soon as possible arguably renders the requirement to publish IMS somewhat redundant, as any material developments between annual and half-yearly reports should already have been disclosed by the company before publication of the relevant IMS.

However, these views are not universally held. For example, the majority of respondents to a Commission consultation on modernisation of the Transparency Directive[4] (the "**TD Consultation**") suggested that investors benefit from access to more information; that preparing an interim management statement is a proportionate request; and that without frequent reporting requirements important information may only be disclosed to privileged investors closest to the issuer (increasing the risk of market abuse).

Amendments

There are two main amendments in this area. Firstly, the Directive-level requirement for issuers to produce IMSs will be removed. Secondly, Member States will be prohibited from imposing more frequent reporting requirements than annual or half-yearly reports unless they can demonstrate that certain conditions are met (discussed further below). This potential derogation was added to the compromise agreement text of the TD Amending Directive and leaves the way open for Member States to retain IMSs. Furthermore, a stock exchange can require issuers which have their securities admitted to trading on all or some of its market segments to publish additional periodic financial information[5].

The potential derogation allows more frequent reporting to be required by Member States where (i) it does not constitute a disproportionate financial burden in that Member State (in particular for small and medium sized issuers) and (ii) the additional information produced is proportionate for what is needed for investment decisions. This suggests that when legislating in this area, Member States will have to assess whether their rules meet the derogation criteria on a country-specific basis, conducting an impact assessment of the additional administrative burden for their financial markets and assessing the needs of investors.

The text of the TD Amending Directive also reminds Member States of the potential dangers of frequent reporting requirements: "an excessive focus on short-term results and performance of the issuers" and "[negative impact] on access of small and medium sized issuers to the regulated markets" (which is viewed as a priority in jurisdictions such as France and Italy). However, the TD Amending Directive does not specify which issuers should qualify as small or medium sized issuers, and proposals to impose differential disclosure requirements across Europe for this segment of the market have not been adopted.

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[4] Feedback Statement, 17 December 2010, p.15; available at: http://tinyurl.com/TDconsult

[5] See recital 4a of the TD Amending Directive. Therefore, the requirement for issuers listed on the sub-segment of the regulated market with additional post-admission obligations (Prime Standard) of the Frankfurt Stock Exchange to publish quarterly financial reports as set forth in the Exchange Rules (*Börsenordnung*) should remain unaffected.

The deadline for all issuers to publish half-yearly financial reports will be extended to three months after the end of the relevant reporting period. This increase in the window for publication of half-yearly reports will, the Commission hopes, allow the reports of small and medium sized issuers in particular to receive more attention from market participants, increasing their visibility.

Impact

Due to the introduction of the potential derogation, it could well be the case that numerous Member States retain the requirement for IMSs for many issuers. For example, the interim management statement requirements could conceivably be abolished for certain smaller issuers only. In addition, given the overarching obligation to disclose inside information as soon as possible to the market, it will not likely be possible for companies to dismantle systems and controls that were established to aid preparation of IMSs. To the extent that such systems and controls reveal inside information, that information will nevertheless need to be disclosed to the market as soon as possible.

2. Changes to notification of major shareholdings regime

Background

Several Member States have already adopted disclosure rules of the kind introduced by the TD Amending Directive in this area (among them: the United Kingdom, Italy, Germany and France). Amendments to the TD in this area will in practice not result in any major changes[6] to the current U.K., Italian, or French[7] regimes, which are currently super-equivalent to the TD with respect to shareholding notification. In practice, the effect of the changes in this area will be to align EU-level requirements with these super-equivalent regimes.

During the TD Consultation, the Commission concluded that gaps in the existing notification of major shareholdings regime may allow holdings of certain financial instruments to be exploited by market participants to permit "virtual" holdings in companies to be built up without triggering shareholder disclosure requirements. In particular, "hidden ownership" of shares and "empty voting" were identified as problems. The U.K. and Swiss regimes, which had already been amended to close this notification gap, were a motivating factor in the formulation of recommendations.

Hidden Ownership: At the end of a cash-settled equity derivative contract, the holder of the relevant instrument may be in a privileged position to acquire the underlying shares (without having any formal or contractual rights to this effect). For example, in a takeover situation, the instrument holder may have a right to terminate a cash-settled equity derivative at any time, and

[6] New regulatory standards for delta calculation may affect legislation in jurisdictions such as the United Kingdom and Italy.

[7] The French regime was amended following increases of stakes in the capital of certain French listed companies as a result of the unwinding of derivative instruments, which were severely criticized by the AMF.

after such a termination its counterparty (which may have hedged its exposure with the underlying shares) may tender the underlying shares in the relevant offer. Changes introduced by the TD Amending Directive are therefore intended to avoid a scenario where a holder of a cash-settled derivative could benefit from the "surprise effect" of acquiring a major holding, without its hidden virtual stake having being known to investors.

Empty Voting: In an "empty voting" scenario, the holder of a cash-settled equity derivative contract asks the underlying shareholder to vote in its interest. Notably, a U.K. Financial Services Authority (now the U.K. Financial Conduct Authority) consultation reported that derivative contract holders were approaching financial institutions holding the underlying shares to push for votes in their interest[8]. The instrument-holder would therefore be able to exert potentially significant voting power over a company without direct ownership of its shares.

Another purpose of the TD Amending Directive with respect to notification requirements is to provide for a harmonized regime for the notification of voting rights, in particular with regard to the calculation of notification thresholds, the aggregation of holdings of voting rights and with respect to exemptions from the notification requirements[9].

Amendments

Holdings of financial instruments that have the same economic effect as holdings of shares, and financial instruments giving rise to entitlements to acquire shares, will be disclosable pursuant to the TD Amending Directive.

Cash-settled financial instruments will have to be "delta-adjusted" to ensure that the calculation of voting rights held by the investor is as accurate as possible. Delta-adjustment is where the notional amount of underlying shares is multiplied by the delta (broadly, the ratio of the derivative price to the underlying value of a security). The European Securities and Markets Authority ("**ESMA**") will be required to develop regulatory technical standards relating to the calculation of voting rights and calculation of delta for delta-adjustment.

Impact

Member States' rules may have to be amended to account for the potential ownership and informal voting powers that may arise under equity derivative contracts. As the U.K. Financial Services Authority was the first EU regulator to identify issues in relation to "hidden ownership" and "empty voting", the DTRs already include notification requirements in relation to

8 See Impact Assessment, European Commission, 3rd Jan 2012, p.20; FSA Consultation Paper 07/20, p.43, available at: http://www.fsa.gov.uk/pubs/cp/cp07_20.pdf

9 According to recital 10 of the TD Amending Directive, Member States shall be permitted to set both lower and additional notification thresholds than those contained in the TD and set more stringent requirements as to the disclosure content of the required notifications. German law, for example, requires a holder of shares corresponding to 10% of the voting rights (or certain higher thresholds) in a listed company to disclose its intentions with regard to the investment (Section 27a German Securities Trading Act). Accordingly, this rule should remain unaffected.

holdings of “qualifying financial instruments” that “result in an entitlement to acquire… shares to which voting rights are attached” or which are “referenced to the shares of a U.K. issuer and have similar economic effects to such qualifying instruments”[10]. The new standards that ESMA will introduce for delta calculation may result in changes to the U.K. regime, which does not currently specify a source for the delta figure for delta-adjustment, though the FSA has stated that it can be taken from “market information providers”[11].

However, concerns have been expressed in the United Kingdom that the DTR regime relating to cash-settled equity derivatives is overly comprehensive and complex, especially given that “hidden ownership” rarely proves a threat in practice[12]. It has also been suggested that the U.K. system fails to address the real risk associated with investors acquiring control by stealth by focusing on the underlying economic interest in shares rather than the potential intention on the part of the instrument-holder to acquire control. The latter was the focus of an alternate regulatory scheme considered but not adopted by the FSA whereby derivative contracts which included a statement of no intent to acquire the underlying shares would be excluded from disclosure requirements[13]. A similar system is in place in the U.S., which grants an exemption from disclosure to investors which invest without the purpose or effect of changing or influencing the control of the target company[14].

Concerns have been raised in other Member States. For example, in consultations with market operators conducted by CONSOB (the Italian Market Authority), participants highlighted the complexity involved in the disclosure of financial instruments with regard to delta adjustment.

3. Additional disclosure requirements for the extractive and primary forest logging industries

Background

The introduction of additional disclosure requirements for issuers in the extractive and primary forest logging industries is intended to help keep communities in developing countries informed of payments made by issuers to governments in connection with the use of oil and gas fields, mineral deposits and forests. It is hoped that additional transparency in this area will discourage corruption and tax evasion.

[10] DTR 5.3.1(1)

[11] FSA Consultation Paper 08/17, p.23, available at: http://www.fsa.gov.uk/pubs/cp/cp08_17.pdf

[12] TD Consultation, p.21

[13] FSA Consultation Paper 07/20, p.49-50.

[14] The “passive investor exemption”: Rule 13(d)-1(b) and (c), Securities Exchange Act of 1934

The changes contemplated by the TD Amending Directive were prompted by guidelines developed by the Extractive Industry Transparency Initiative (EITI) and follows in the wake of disclosure requirements introduced by the Dodd-Frank Act, which are broadly similar in scope.

Section 1504 of the Dodd-Frank Act requires the SEC to adopt rules requiring all U.S. or foreign issuers engaged in the commercial development of oil, natural gas or minerals to disclose in an annual report all material (more than USD 100,000) payments made to governments. Payments are defined as including royalties, fees and licenses, production entitlements, bonuses, dividends, infrastructure improvements and, significantly, any taxes based upon corporate income, production and profits. However, on July 2, 2013 a decision by the U.S. federal district court for the District of Columbia vacated the rule adopted by the SEC in August 2012[15], which would have introduced reporting requirements covering payments from October 1, 2013. The SEC must now either appeal the decision or restart its rulemaking process to implement Section 1504 of the Dodd-Frank Act.

Amendments

Issuers whose securities are admitted to trading on a regulated market and which have activities in the extractive or logging of primary forest industries will be required to disclose payments of over EUR 100,000 made to governments in the countries in which they operate in an annual report to be made public no later than six months after the end of each financial year[16]. This requirement will complement similar changes introduced in connection with the reform of the EU Accounting Directives (Directives 78/660/EEC and 83/349/EEC).

Impact

Member States will have to introduce requirements for this new form of annual reporting in national legislation. Companies in the oil, gas and forestry industries should prepare to comply with such obligations. It is possible that, in the context of other EU legislative developments, the wider impact of these requirements may be to encourage legislators to enact more widespread country-by-country reporting requirements on issuers generally.

4. Other changes

The TD Amending Directive also makes a number of other changes to the existing transparency regime:

- Preparation of annual financial reports in a single electronic reporting format will be mandatory from 1 January 2020.

[15] See American Petroleum Institute et al. v. Securities and Exchange Commission

[16] See Chapter 9 of Proposal for a Directive of the European Parliament and of the Council on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings; available at: http://tinyurl.com/ExtrPayment

- Sanctions for breach of Transparency Directive requirements may be imposed on members of administrative, management or supervisory bodies of the relevant issuer, or other individuals who can be held liable for those breaches according to national law. The Transparency Directive originally only specified that 'persons responsible' for the issuer should have civil or administrative penalties imposed upon them for breach of regulatory requirements. Some Member States already have clear and extensive administrative penalties in their legislation. The U.K. regime, for example, currently allows for an unlimited fine to be imposed on the listed company itself or a (former) director of the listed company knowingly concerned in a breach of market transparency rules[17].

- The period for which issuers must ensure the annual and half-yearly financial reports they produced are publicly available will be extended from five years to ten years.

- The Commission, with the assistance of ESMA, will have powers to take measures to improve national officially appointed storage mechanisms and develop technical criteria for access to regulated information at the Union level. This may affect the operation of the National Storage Mechanism, which was introduced by the United Kingdom in 2010 in response to the TD's obligation on Member States to maintain a mechanism for storing regulated information.

- The rules on choice of home Member State will be tightened to prevent an issuer from avoiding transparency obligations by failing to declare a home Member State for the purposes of the Transparency Directive.

III. RELATED DEVELOPMENTS

The introduction of country-by-country reporting of government payments for certain issuers can be seen as part of a wider policy initiative towards improving the transparency of the activities of issuers, and in particular multinational corporations.

In a press release issued on June 12, 2013,[18] Michel Barnier, European Commissioner for Internal Market and Services, drew connections between these new disclosure requirements and plans to introduce country-by-country reporting for certain financial institutions under CRD IV. Notably, Commissioner Barnier called on the European institutions to introduce tax disclosure requirements, similar to those in CRD IV, for "all large companies and groups".

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[17] Section 91, U.K. Financial Services and Markets Act 2000

[18] 'Commissioner Barnier welcomes European Parliament vote on the Accounting and Transparency Directives (including country by country reporting)', MEMO/13/546; available at: http://europa.eu/rapid/press-release_MEMO-13-546_en.htm

IV. NEXT STEPS

Once the TD Amending Directive has entered into force, following formal approval by the European Council, Member States will have two years to transpose its requirements into national law. This is expected to take place by mid-2015.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Capital Markets in the "Practices" section of our website at http://www.clearygottlieb.com.

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