Arthur Cox & C0

Submission to Financial Regulator

Disclosure of Grants of Security over Shares

Consultation Paper CP36

1. Introduction

This is a submission in support of Option One as identified in the Financial Regulators Consultation Paper CP36 "Disclosure of Grants of Security over Shares" hereinafter referred to as the "Consultation Paper".

In endorsing Option One, we also propose that the Financial Regulator might consider new regulations which would require companies to disclose any notification received from a PDMR where the PDMR discloses an intention to buy or sell shares. This is explained further below.

As a starting point, this submission looks at the circumstances which emerged in December 2008 regarding the security which had been granted by the Deputy Chairman of Carphone Warehouse and questions whether the grant of a security over shares should be regarded as so significant as requiring immediate disclosure. Our submission then considers the impact such a disclosure obligation could have on a person's right to privacy. We also look at the requirements under the Model Code as well as an analysis of the relevant legal provisions.

2. Grant of Security Over Shares in Carphone Warehouse as disclosed in December 2008

When it became known in December 2008 that Mr David Ross, the Deputy Chairman of Carphone Warehouse, had granted a security over his 17% shareholding in the company, the market also learnt that Mr. Ross was in personal financial difficulty on account of large property investments he had made. The combination of a security interest over such a large percentage shareholding and the fact that Mr. Ross was in significant financial difficulty suggested that his lenders might soon force a sale of this significant shareholding in the company.

In fact, given the magnitude of the financial difficulties which were being experienced by Mr. Ross at that time, the existence of a pledge over his shares was somewhat academic, since all of his shares could be expected to be sold with equal speed in the event of his lenders calling in their loans.

There is a widely accepted assumption that investors can be expected to be influenced by share dealing made by directors of publicly quoted companies. However, we submit that the following Consultation Paper goes too far when it states that *"While granting security over shares is not equivalent to purchasing or selling those shares, it can indicate a significant change in the level or nature of the commitment of a PDMR to the company"*. There is no basis for this statement. The statement suggests that the mere knowledge of a grant of security over shares means a conclusion can be drawn as to a PDMR's motivation. Knowledge that a security had been provided or withdrawn tells the market absolutely nothing about an individual's intentions, commitment or otherwise. On its own it does not indicate either an increase or a decrease in a person's commitment financial or otherwise to the company. In fact, it is submitted that that the grant of a security over shares held by a PDMR will not always be significant from the point of view of an investors. For instance, a PDMR may be pledging shares to:

(a) Borrow money to resolve a marital breakdown;

(b) Give capital to his children;

(c) Support his parents or family;

(d) Buy options in the company;

(e) Buy shares in the company;

(f) Buy a second home;

(g) Make an investment;

(h) Repay a debt;

(i) Repay a distressed bank; or

(j) Pay family medical expenses.

Without knowing the motive for the security arrangement, any attempt by the market to interpret a grant of security in the case of any of the above examples would simply be speculation, liable to be misconstrued and provides no insight into the mind of the PDMR member without full knowledge of the financial and other circumstances of a PDMR. This is completely different from the knowledge which is obtained from the information that the PDMR has sought consent from the company to either increased or reduced his actual investment in the company through either a purchase or sale of shares.

3. **Right to Privacy**

The obligation to disclose of information which might have a material effect on the price of shares in a quoted company is not absolute. For instance, a serious deterioration in the financial health of the chief executive of a company is likely to have a negative effect on the price of the company's shares. Such information is therefore undoubtedly price sensitive but there is no obligation in the Market Abuse Rules Regulations which requires a chief executive to disclose this information to either his company or the market. In fact a chief executive is entitled to maintain the privacy of this information until such time as he or she chooses to make it public. The same applies to most of the examples in 2(a) to (j) above. By forcing a PDMR to disclose the grant of a security over his shares will invariably force the PDMR to disclose his/her private motivation for the security in order ensure that the disclosure is not misconstrued by the market. As there can be significant time lags in implementing or unwinding financing and security arrangements, this can mean that the PDMR may have to provide even more background information so that the arrangements can be understood by the market.

This issue of privacy becomes more extreme where the disclosure obligation extends into dealings by a spouse of a PDMR. For example, it is not unknown for a PDMR to transfer shares to his/her spouse as part of a marital separation (ie not a divorce) on the basis that the shares are not to be sold for specified period but may be mortgaged in the interim to raise finance. Forcing the disclosure of this type of arrangement would be a considerable intrusion into the private affairs of a PDMR.

In regard to what a regulator may require a person to disclose from his/her personal affairs, the Data Protection Directive 95/46/EC, permits Member States to restrict the normal data protection rights of individuals where necessary to safeguard:

(a) national security;

(b) defence;

(c) public security;

(d) the prevention, investigation, detection and prosecution of criminal offences, or of breaches of ethics for regulated professions;

(e) an important economic or financial interest of a Member State or of the European Union, including monetary, budgetary and taxation matters;

(f) a monitoring, inspection or regulatory function connected, even occasionally, with the exercise of official authority in cases referred to in (c), (d) and (e);

(g) the protection of the data subject or of the rights and freedoms of others." (Article 13).

Under Section 8 of the Data Protection Acts 1988 and 2003 (DPAs), this has in effect been transposed as follows:

> *"8.-Any restrictions in this Act on the processing of personal data do not apply if the processing is-*
>
> *(a) in the opinion of a member of the Garda Síochána not below the rank of chief superintendent or an officer of the Permanent Defence Force who holds an army rank not below that of colonel and is designated by the Minister for Defence under this paragraph, required for the purpose of safeguarding the security of the State,*
> *(b) required for the purpose of preventing, detecting or investigating offences, apprehending or prosecuting offenders or assessing or collecting any tax, duty or other moneys owed or payable to the State, a local authority or a health board, in any case in which the application of those restrictions would be likely to prejudice any of the matters aforesaid,*
> *(c) required in the interests of protecting the international relations of the State,*
> *(d) required urgently to prevent injury or other damage to the health of a person or serious loss of or damage to property,*
> *(e) required by or under any enactment or by a rule of law or order of a court,*
> *(f) required for the purposes of obtaining legal advice or for the purposes of, or in the course of, legal proceedings in which the person making the disclosure is a party or a witness,*
> *(g) [deleted 2003 Act]*
> *(h) made at the request or with the consent of the data subject or a person acting on his behalf."*

This means that except where the Financial Regulator is acting pursuant to an "enactment" (which is defined as "a statute or a statutory instrument (within the meaning of the Interpretation Act, 1937)" there are data protection difficulties with seeking to compel directors to disclose personal details relating to their private mortgage dealings. Such disclosures would be likely to be "excessive" and therefore contrary to the requirements of Section 2(1)(c) of the DPAs.

4. Application of Model Code

The purpose of the Model Code is "to ensure that PDMRs and employee insiders[1] do not abuse, and do not place themselves under suspicion of abusing, inside information which they may have." A pledge or other grant of security will not in normal circumstances be regarded as an attempt to abuse inside information. This reflects the Market Abuse regime where it is clear from Article 2 of MAD (and Recital 18) that "market abuse" involves the acquisition or disposal of financial instruments and would not therefore normally apply to the grant of a security over shares.

[1] The Model Code no longer applies to employee insiders.

If a director/PDMR is intending to grant a security arrangement over his shares, the director/PDMR will have to obtain consent under the Model Code. This is a requirement in paragraph 1(c)(v) of the Model Code which defines a dealing in shares as including "using as security, or otherwise granting a charge, lien or other encumbrance over the securities of the company".

When a director/PDMR applies for dealing consent under the Model Code, the consent must be withheld in the circumstances specified by the Code but, other than this, the director/PDMR can assume that the consent will be forthcoming.

Even where circumstances are such that consent is not ordinarily to be given under the Model Code, the sale of shares by a director in severe financial difficulty is one of the exceptional circumstances where clearance to deal can be given even when the company is in a prohibited period. Where a PDMR has sought and obtained consent to sell shares for the purpose of repaying a loan, there should be a legal requirement on the company/PDMR to disclose the fact that the PDMR has been given this consent.

5. Interpretation of existing Statutory Disclosure Obligations

The announcement which was issued by the Financial Services Authority ("FSA") in the UK on 9 January 2009 has some relevance for the interpretation of the Market Abuse Directive as it has been implemented in Ireland. The relevant aspects of the announcement can be summarised as follows:-

- Under Chapter 3 of the UK Disclosure and Transparency Rules (the "DTR 3"), directors/PDMRs and their connected persons, must notify their company in writing of the occurrence of all transactions conducted on their own account in the shares of the company. The wording of this obligation is taken directly from Article 6(1) of the Market Abuse Directive ("MAD") and the same obligation is contained in Regulation 12 of the Irish Market Abuse (Directive 2003/6/EC) Regulations 2005.

- In the announcement, the FSA is effectively admitting that the meaning of the words "transactions conducted on their own account…" is unclear and this lack of clarity is (presumably) why there are differing approaches in some other Member States (eg in France and Germany, pledges granted by directors over shares in their own companies are not disclosable).

- The announcement also refers to the guidance which the FSA issued in its List! 11 in September 2005 where its said the following:-

  > *"It is impossible to set out a definitive 'on own account' test that would be applicable to all transactions that a PDMR may conduct. However, we think the following principles suggest that a transaction by a PDMR is 'on own account':*
  >
  > *• a transaction which is the result of an action taken by a PDMR or otherwise undertaken with their consent;*
  >
  > *• a transaction whose beneficiaries are mainly PDMRs; and*
  >
  > *• transactions having a material impact on a PDMR's interest in an issuer."*

- Notwithstanding this lack of clarity on the meaning of "own account", the FSA states in the announcement that grants of security over shares (by the creation of a security interest such as a pledge, mortgage or charge) are covered by the disclosure requirement in DTR 3 and that this is consistent with the statements made in List! 11 in September 2005. The FSA also states in the announcement that those PDMRs who have granted security over their shares should disclose this to the market as soon as possible.

- The announcement also states that, given the circumstances, the FSA is not intending to take enforcement action in respect of prior failures to notify the market of grants of security. This reference to "prior failures" is unfair given the admission in the announcement that the existing disclosure obligation is unclear and the FSA believes that there is now a need to reach a common understanding on the detail of the MAD requirements in this area with the European Commission and the FSA's counterparts in the Committee of European Securities Regulators. In fact, given this admitted lack of clarity, it is extremely doubtful that the FSA could have had any success if it had tried to prosecute anyone for these alleged "prior failures".

The FSA's announcement is relevant in terms of Irish law as it can be read as an authoritative recognition that the meaning of the words "transactions conducted on their own account…" is unclear[2]. Since the same words are also used in Regulation 12 of the Irish Market Abuse (Directive 2003/6/EC) Regulations 2005, this lack of clarity makes them incapable of enforcement. Furthermore as the words are taken directly from the Article 6(1) of the Market Abuse Directive, the legal deficiency which is created by this lack of clarity can only be remedied by primary legislation and not a statutory instrument. Until this happens it is difficult to see how these words can be regarded as requiring directors of Irish companies to make the disclosure now being insisted upon by the FSA.

The disclosure obligations in Part IV of the Companies Act 1990 do not require a director to make any disclosure in respect of any security which he may grant over shares acquired by him. This is so because a disclosure under Part IV is required where a director acquires or disposes of an interest in share. Where a director grants a security over his shares, he is regarded for the purpose of Part IV as still having an interest in the shares.

A separate notification obligation can arise under the Transparency Regulations where a director/PDMR holds 3 per cent. or more of the shares of the company and the director/PDMR confers a security over his shares which transfers the voting rights in those shares to the bank. In our view no notification obligation is likely to arise in the context of a standard share pledge as it would not to impact on a director/PDMR's ability to vote the shares. A notification obligation may arise however if the terms of the security are such that the director/PDMR ceases to retain control of the voting rights. If a company receives a notification from a director/PDMR under the Transparency Regulations, it must notify the market of the notification as soon as possible and, in any event, not later than the end of the following trading day.

6. Regulation 10 of the Irish Market Abuse (Directive 2003/6/EC) Regulations 2005

The Consultation Paper states *"Where a PDMR is known by the market to have a significant shareholding and the market does not know that those shares are pledged to finance other activities, regard might be had to the shareholding on the basis of an incorrect estimation of its significance. Disclosure of such information also seems to be within the spirit of the EU Market Abuse Directive (2003/6/EC), on which the Regulations are based. The Regulations state in Part 1, Regulation 2(1) that " 'information which, if it were made public, would be likely to have a significant effect on the prices of financial instruments or related derivative financial instruments' means information that a reasonable investor would be likely to use as part of the basis of the investor's investment decisions". This could be the case, at least in some situations, where PDMRs have granted security over their shareholdings".*

Under Regulation 10 of the Irish Market Abuse (Directive 2003/6/EC) Regulations 2005 a company must notify a Regulated Information Service without delay of any inside information which "directly concerns" it. This obligation applies only to the companies. There is no equivalent obligation on shareholders or PDMRs. There is no express requirement for a company that is aware of a

[2] In fact several leading law firm in the UK has publicly stated that the FSA is wrong in saying that these words are to be interpreted as requiring disclosure of security arrangements.

shareholder having granted security over his shares to disclose that information. Equally it is our view that where a PDMR creates a standard pledge over a relatively small percentage shareholding in the capital of the company, it is unlikely to constitute inside information and therefore no notification obligation should ordinarily arise under this rule. It will only be in exceptional cases that the financial circumstances or arrangements of a shareholder/director/PDMR could potentially constitute inside information directly concerning the company which would, if known to the company, require it to make an announcement under Regulation 10 of the Irish Market Abuse (Directive 2003/6/EC) Regulations 2005. Also in order to determine whether circumstances are sufficiently exceptional as to require disclosure, the question first has to be asked what is "a significant shareholding" – is to be measured as significant in the context of the PDMR's wealth or significant by some measure in relation to the share capital of the company or by reference to some absolute monetary value. The statement also begs the question of whether significance is to be measured by way of level of attention or importance to the life of the individual which in turn raises the question of how that is to be judged.

7. Companies Listed on IEX

While companies listed on IEX are intended to benefit from a flexible regulatory regime in terms of the production of a prospectus or the listing rules which must be complied with, there is no sustainable reason for having an entirely distinct regulatory regime governing market abuse and disclosure of dealings for these companies. It is submitted that investors and companies would be better served if same regulatory regime applied to both IEX and the Official List as is the case in the UK.

Rule 17 of both the IEX Rules provide that a company must issue a notification without delay of any deals by directors disclosing, insofar as it has such information, the information specified by Schedule Five. "Deals" are defined as including any change whatsoever to the holding of IEX securities of an IEX company in which the holder is a director of the IEX company or part of a director's family (and for the purpose of rule 21 an applicable employee) including….the grant to, or acceptance by, such a person of ….any right or obligation, present or future, conditional or unconditional, to acquire or dispose of any such securities. This definition is wide enough to apply to the grant of a security over a directors shares.

However, the IEX Rules do not actually impose any obligation on directors to disclose this information with the consequence that a directors cannot be criticised if he decides not to disclose the grant of a security over his shares.

Arthur Cox
22 May 2009