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Emergency UK provisions requiring disclosure of short positions in relation to rights issues in UK-listed companies

On 13 June 2008, the FSA published, as an emergency measure, new provisions intended to provide for the disclosure of short positions in shares in UK-listed companies which are engaging in rights issues.[1] The new provisions, which take effect from 20 June 2008, require the disclosure of short positions representing 0.25% or more of the issued capital of a UK-listed company (including any non-UK company with a secondary listing in the UK) that has announced a rights issue.

As a result, hedge funds and others engaged in shorting in advance of or during a rights issue by a UK-listed company will, where those short positions reach the notification threshold, be required to disclose their positions to the market. The new provisions will also reduce business for pension funds that lend securities (in which they hold long interests) to enable others to short the relevant stock. The FSA hopes that the new provisions will reduce market distortion in the current turbulent climate in which short positions can make rights issues vulnerable to the trading price falling below the offer price, making them almost impossible to price, let alone fulfil; the most significant examples of this in recent times have been bank capital-raisings such as those by HBOS, The Royal Bank of Scotland and Bradford & Bingley. In the FSA's opinion, failure to make adequate disclosure in accordance with the new provisions will constitute an offence of market abuse in the UK. Penalties for market abuse include fines, public censure and, in extreme cases, revocation of FSA authorisation.

In response to "several queries" as to how the new provisions would operate in practice, on 17 June 2008 the FSA published some "Frequently Asked Questions" ("**FAQ**").[2] The FAQ provide answers to many important questions that arise from the drafting of the new provisions, but concerns remain about both the implementation of certain aspects of the new provisions and the manner in which the FSA has introduced these provisions.

I. The New Provisions

Under the new disclosure provisions any person who, at any time during a "rights issue period", holds a short position that reaches or exceeds 0.25% of the issued capital of a company must give "adequate disclosure" in relation to that short position. The "issued capital of a company" for this purpose means the issued share capital prior to the rights issue (see Question 10, FAQ). Whether a person has a disclosable short position on any given day is determined by the position held by them at midnight on that day (see Question 19, FAQ).

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[1] See http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/057.shtml and the Short Selling Instrument 2008 that may be found at http://www.fsa.gov.uk/pubs/press/PN0572008_instrument.pdf

[2] See http://www.fsa.gov.uk/pubs/other/Short_selling_faqs.pdf

A "rights issue period" is defined as the period beginning on the date that a company announces a rights issue and ending on the date that the shares issued under the rights issue are admitted to trading on a prescribed market, which is typically several weeks later.

Disclosure must be made via a Regulatory Information Service (such as the London Stock Exchange's RNS service) on or prior to 3.30 p.m. London time on the business day following the date on which the disclosable short position is first held or exceeded. The FSA has published a template for RIS disclosures of this nature.[3]

The disclosure must state:

- the name of the person holding the disclosable short position;
- the disclosable short position itself; and
- the name of the relevant issuer.

According to the FAQ, a fund manager should aggregate the positions of all of its discretionary funds for the purposes of determining whether or not it has a disclosable short position (see Question 23, FAQ).

Although the wording of the new provisions is unclear on the point, the FSA has stated in its FAQ that short positions and long positions can be netted in determining whether or not a disclosable short position has been reached or exceeded, although a person cannot net off a short position (i) held in the relevant company's existing shares with a long position in rights under the rights issue or (ii) against any shares in the relevant company that it has borrowed (see Question 9, FAQ). Only the aggregate net short position will need to be disclosed and not, for example, details of individual long and short positions held by the same person (see Questions 11 and 12, FAQ).

The new provisions do not explicitly provide for the treatment of positions already in existence when the rights issue period commences. However, the FSA has attempted to clarify the matter in the FAQ. It appears that, despite the use of the words "reached or exceeded" in the new MAR1.9.2BA, the FSA intends that any person who has a short position of 0.25% or greater in a company during a rights issue, whether the position was originally acquired prior to the rights issue period or not, is required to disclose that position (see Question 16, FAQ). This therefore covers positions already held in relation to any rights issue announced prior to 20 June 2008 which is ongoing after that date.

The FAQ make clear that once a person has given adequate disclosure that he has reached or exceeded a disclosable short position of 0.25%, no further disclosure is required for later increases or decreases in his position. This contrasts with the series of thresholds in the Disclosure Rules and Transparency Rules sourcebook relating to disclosures of major shareholdings or under the Takeover Code in the context of companies subject to an offering. However, the FSA suggests that (i) a person may choose, of his own volition, to disclose a reduction in a short position held below the 0.25% threshold[4] and (ii) additional notification thresholds above 0.25% may be introduced in the future if "experience suggests that this would add value to the regime" (see Questions 17 and 18, FAQ). It is strange from a policy perspective that a reduction below the 0.25% threshold is not required to be notified, because the market may as a result over-estimate the extent of outstanding short positions.

On 18 June 2008, the FSA published for the first time a list of issuers that it considered to be in a rights issue period at that date.[5] The FSA stressed that it does not undertake to update the list, which was provided on a "non-liability basis", and that market participants must satisfy themselves as to whether issuers in which they hold short positions have entered rights issue periods.

3 See http://www.fsa.gov.uk/pubs/forms/Form_TR3.doc

4 Any subsequent increase in that short position reaching or exceeding the 0.25% threshold will, of course, require a further notification.

5 See http://www.fsa.gov.uk/pubs/other/Shortselling_issuers.pdf

II Some issues requiring resolution

- The new provisions require that "any form of economic interest" be taken into account in determining whether or not a disclosable short position has been reached or exceeded. In the FAQ, the FSA suggests that an economic interest covers "any instrument which gives the holder an exposure, whether direct or indirect, to the shares of the company" (see Question 4, FAQ). As a matter of English law the word "interest" is generally used to mean a proprietary interest and therefore "economic interest" is a legal oxymoron. What the FSA appears to mean in using the word "interest" is pure economic exposure.

- No definition of either "short position" or "rights issue" is provided, presumably on the basis that market participants will understand these phrases and will interpret them according to common parlance.[6] However, an obvious consequence of the FSA's use of the undefined term "short position" is that certain trading activities that achieve similar results might not be disclosable if they cannot properly be described as "short positions" (although, following the publication of the FAQ, it is clear that the FSA considers that "any form of economic interest" includes options, whether exercisable or not during the rights issue period (see Question 14, FAQ)). Since the new provisions only apply to rights issues, they will apparently have no impact on short sales occurring in respect of other means of capital raising not involving a rights issue, such as the issuance of debt.

- The provisions appear to apply to disclosures of short positions held in non-UK companies with a secondary listing on a UK regulated market. As a result, persons in the UK holding short positions in, for example, certain continental-European listed stocks would often be faced with a choice of publicly disclosing their position or committing a market abuse offence. The FSA has acknowledged this in the FAQ, but far from seeking to clarify that only UK issuers with a primary UK listing are affected by the new disclosure provisions, the FSA instead considers that rights issues and other pre-emptive methods of capital raising "tend to be more common in the UK". In its view, therefore, disclosure obligations under the new provisions will "primarily relate to UK incorporated companies" (see Question 2, FAQ). Conversely, according to the new provisions, the FSA would consider a failure to notify as constituting market abuse even where technically committed by persons outside the UK. The position of non-UK persons is difficult. For policy reasons their conduct is likely to have to be captured, but obvious difficulties of enforcement arise. Unlike in the context of abusive long positions, it is difficult to cure the situation by requiring divestiture since the relevant short sellers will generally have nothing to divest themselves of. This issue is not addressed by the FAQ.

- Finally and unusually, the new provisions were not subject to the normal public consultation process. As the changes made are to the Code of Market Conduct, the FSA must therefore consider that there is "an urgent need" to amend the Code without allowing for representations.[7] Curiously, one of the new provisions (MAR1.9.2BA) has been designated as a rule. In order to implement new rules without consultation, the FSA must consider that the delay involved in consultation would "prejudice the interests of consumers".[8]

Disconcertingly for the industry, the FSA warned when publishing the new provisions that it was considering

[6] Despite choosing not to use it explicitly in the new provisions, the FSA has suggested that the definition of "rights issue" in the FSA's Glossary that applies in the context of the Listing Rules is "appropriate" (see Question 5, FAQ).

[7] See section 121(6) of the Financial Services and Markets Act 2000.

[8] See section 155(7) of the Financial Services and Markets Act 2000.

the need for "further measures" in this area, including (i) restricting the lending of stock of securities in rights issues that enables short selling and (ii) restricting short sellers from covering their positions by acquiring rights to the newly issued shares. It is to be hoped that, unlike in the present case, the FSA will not impose any such "further measures" before due and proper consultation with the industry; and that there will soon be proper consultation on the above emergency measures themselves.

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