

Financial Institutions Advisory and Asset Management | September 24, 2008

FSA's measures against short selling – a briefing note

On 18 September 2008, the UK's FSA joined the global clampdown on short selling by adopting provisions which effectively prohibit the creation of a net short position in the issued share capital of a "UK financial sector company" whose shares are traded on a UK exchange or any increase in such a position that a person had immediately before 19 September 2008.

The new rules also impose a disclosure obligation on any person holding a net short position representing an economic interest of 0.25% or more of the issued share capital of a UK financial sector company.

The FSA's action coincides with similar action taken across the Atlantic by the SEC on 18 September 2008, and, indeed, elsewhere in the world.

On 23 September 2008, after receiving feedback on the new rules, further clarification was provided by the FSA and the provisions adopted on 18 September 2008 were slightly amended. The purpose of this briefing note is to discuss the new rules on short selling in the light of the clarification provided.

The new rules apply in relation to those UK financial sector companies whose shares are admitted to trading on a market established under the rules of a recognised investment exchange (essentially the London Stock Exchange, AIM and PLUS) or in respect of which a request for admission to trading on such a market has been made. All references in this note to "UK financial sector company" are to be read as references to such companies.

1. Legal nature of the FSA's measures

In the US, the SEC imposed a ban on short selling of shares in certain financial firms by making emergency orders pursuant to the Securities Exchange Act of 1934.

By contrast, the FSA has not adopted any order or measure that prohibits outright any short sales of financial stocks. It has instead taken a different legal route to achieving such a ban.

Under UK law, there is a civil offence called "market abuse", the commission of which can attract FSA sanctions, including financial penalties. Market abuse is prohibited by section 118 of the Financial Services and Markets Act 2000. This Act confers upon the FSA the power to describe what does and does not amount to market abuse. The FSA is required to publish a Code of Market Conduct (the "Code") and in it to provide adequate guidance on what constitutes market abuse.¹

It is this power to specify particular descriptions of behaviour that amount to market abuse that the FSA has utilised to ban short selling of certain financial stocks. The Code contains a number of 'evidential' provisions (designated by the letter 'E') which specify descriptions of behaviour that amount to market abuse.

The FSA's Short Selling (No 2) Instrument 2008, adopted on 18 September 2008², and entering into force on 12.01 a.m. 19 September 2008, adds two new evidential provisions to the Code. These are paragraph 1.9.2C E, which effectively regards short selling of financial sector

¹ The Code can be found at: <http://fsahandbook.info/FSA/html/handbook/MAR/1>

² See at: http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf as amended by the Short Selling (No 3) Instrument 2008, adopted on 23 September 2008 (at: http://www.fsa.gov.uk/pubs/other/short_selling_instrument.pdf).

stocks in the current financial environment to be market abuse, and paragraph 1.9.2D E, which effectively imposes certain disclosure requirements.³

Therefore, even though there has been no change in the statutory regime, the FSA's fresh interpretation of the law, as reflected in the new evidential provisions, is that short selling of certain financial stocks is market abuse. This interpretation will continue to apply until 16 January 2009 (when the new evidential provisions cease to have effect, unless extended by the FSA).

2. Short selling of UK financial sector stocks

The following conduct amounts, in the opinion of the FSA, to market abuse:

- Entering into a transaction that has the effect of creating a net short position in a UK financial sector company; or
- Entering into a transaction that has the effect of increasing any net short position in a UK financial sector company that the person had immediately before 19 September 2008.⁴

Hence, the creation of a net short position or any increase in a pre-existing net short position in a UK financial sector company, where this results from a single transaction or a number of transactions, will now amount to market abuse, irrespective of whether the short position is a naked or a covered one.⁵

The restriction does not apply to a transaction entered into or an order placed before 19 September 2008.⁶ Hence, if a net short position arises or if a pre-existing net short position is increased as a result of a transaction entered into or an order placed before 19 September 2008, no violation of the restriction ensues (although there may be disclosure obligations as discussed below).

³ Evidential provisions specify descriptions of behaviour that "tend to establish" breach of or compliance with a rule: section 149 of the Financial Services and Markets Act 2000.

⁴ See paragraph 1.9.2C E(1) of the Code.

⁵ See FAQ 5 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

⁶ See paragraph 1.9.2C E(3) of the Code.

Nor does the restriction apply to a net short position that arises or increases, not as a result of any transaction after 19 September 2008, but due to a change in delta as a result of changing market conditions (although this may trigger the disclosure requirements discussed below).⁷

Hedging a long position in a convertible bond by taking a short position in the issuer's equity is allowed as long as there is no net short position created in the equity share capital of the company.⁸

Net short position

"Net short position" is defined as a net short position which gives rise to an economic exposure to the issued share capital of a company, taking into account any form of economic interest in the shares of the company.⁹ This encompasses any instrument, including contracts for differences, spread bets, options and so on, giving rise to an exposure, whether direct or indirect, in the equity share capital of a company. Equity share capital includes shares and convertible bonds but excludes debt securities or credit default swaps.¹⁰

The prohibition covers all types of short selling. As long as a net short position is established or increased, it does not matter how it came about. Both OTC transactions and those concluded on-exchange are covered.¹¹

Stocks affected by the restrictions

The restrictions apply to a net short position in a "UK financial sector company". This is a company which is a:

- UK bank; or
- UK insurer; or

⁷ See FAQ 21 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

⁸ See FAQ 24 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

⁹ See new definitions in the FSA Handbook glossary.

¹⁰ See FAQs 8 and 26 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

¹¹ See FAQ 25 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

- UK incorporated parent undertaking of a UK bank or UK insurer where the main business of the group to which the parent undertaking and the company belong is financial services.¹²

The FSA has indicated in a non-exhaustive list that the following entities fall within the definition of “UK financial sector company”: Admiral Group plc, Alliance & Leicester plc, Alliance Trust plc, Arbuthnot Banking Group plc, Aviva plc, Barclays plc, Bradford & Bingley plc, Brit Insurance Holdings plc, Chesnara plc, Close Brothers Group plc, European Islamic Investment Bank plc, Friends Provident plc, HBOS plc, Highway Insurance Group plc, HSBC Holdings plc, Investec plc, Islamic Bank of Britain plc, Just Retirement Holdings plc, Legal & General Group plc, Lloyds TSB Group plc, London Scottish Bank plc, Novae Group plc, Old Mutual plc, Prudential plc, Rathbone Brothers plc, Royal Bank of Scotland Group plc, RSA Insurance Group plc, Schroders plc, St James's Place plc, Standard Chartered plc, Standard Life plc, TAWA plc.¹³

Positions on indices or baskets of securities

Where an economic interest in a UK financial sector company arises due to a position in a basket of securities, index or an exchange-traded fund and the components of the basket, index or fund are predominantly UK financial sector companies, then such economic interest must be included in any aggregation of a person's economic interest in the company (i.e. when arriving at the net position or when determining whether the disclosure obligations discussed below are triggered).¹⁴

Thus, the short sale of an index which does not have a predominance of UK financial sector companies within it, but which creates a new or increased net short position in one or more UK financial sector companies, on its own is permitted.¹⁵ However, to preclude

circumvention of the prohibition by the use of index trading, a person is not allowed to go short on an index and then take long positions in its constituents other than one or more UK financial sector companies, if to do so would result in a new or increase net short position in one or more UK financial sector companies.¹⁶

Exemption for market makers

The restrictions apply to all persons. There is, however, an exemption for any person “acting in the capacity of a market maker”.¹⁷ A market maker is an entity that ordinarily, as part of its business, deals as principal in equities, options or derivatives (whether OTC or exchange-traded):

- to fulfil orders received from clients, to respond to a client's requests to trade or to hedge positions arising out of those dealings; and/or
- in a way that ordinarily has the effect of providing liquidity on a regular basis to the market on both bid and offer sides of the market in comparable size. Trading in circumstances other than genuinely for the provision of liquidity is not exempt.¹⁸

A person does not have to be registered as “market maker” with an exchange or trading platform to benefit from the exemption. However, it is essential that any new or increased net short positions arise from genuine market making and liquidity provision. This means that market makers are not expected to hold significant short positions, other than for brief periods. New or increased net short positions arising from proprietary trading strategies where the main intention is to create a short position are not exempt.¹⁹

Fund managers

If a fund manager holds short positions on behalf of a non-discretionary client, the restrictions apply to the

¹² See new definitions in the FSA Handbook glossary and Short Selling (No 3) Instrument 2008.

¹³ See list at http://www.fsa.gov.uk/pubs/handbook/list_instrument200850.pdf.

¹⁴ See FAQ 15 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

¹⁵ Ibid.

¹⁶ Ibid.

¹⁷ See paragraph 1.9.2C E(2) of the Code.

¹⁸ See FAQ 9 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

¹⁹ See FAQ 9 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

client. In the case of discretionary clients and where an individual fund is housed within a legal entity other than the fund manager, the restrictions apply to the legal entity housing the individual fund.²⁰

Different trading desks

If a firm has several trading desks that are part of the same legal entity, the aggregate position of the legal entity is taken into account, excluding positions falling within the market maker exemption.²¹

Temporary nature of restrictions

The provisions will cease to have effect on 16 January 2009, unless the FSA decides to extend them.²²

3. Disclosure of net short positions

The FSA also considers it to be market abuse for a person with a “disclosable short position” in a UK financial sector company to fail to provide “adequate ongoing disclosure” of that position.²³

Disclosable short positions

“Disclosable short position” means a net short position which represents an economic interest of 0.25% or more of the issued share capital of a company (i.e. 0.25% or more of the issued ordinary and preference shares).²⁴

Thus, any person with a net short position representing an economic interest of 0.25% or more of a UK financial sector company’s issued share capital must make “adequate ongoing disclosure”.

Adequate ongoing disclosure

“Adequate ongoing disclosure” means disclosure made on a Regulatory Information Service (for example, the RNS of the London Stock Exchange) by no later than 3.30 pm on the business day following each day on which the disclosable short position is held.²⁵

Information to be given in such disclosure includes the name of the person with the position, the amount of the position and the name of the company to which it relates.²⁶ The FSA has published a form for making the required disclosure.²⁷

The disclosure is made on a net basis: the disclosable position is any net short position of 0.25% or above.²⁸ There is no requirement to provide a breakdown of any individual long or short positions underlying the disclosable net position.²⁹

If a person’s net short position falls below 0.25%, then one last disclosure of that fact is required.³⁰

Exemption for market makers

Those holding a disclosable short position by virtue of their activities as market makers are exempt from the disclosure obligations.³¹

Fund managers

In the case of short positions held by fund managers on behalf of non-discretionary clients, the disclosure obligation applies to the client. The fund manager can make a disclosure on behalf of the client, but must clearly identify that it is the client who holds the disclosable position.

²⁰ See FAQ 11 on the FSA’s website at:

http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

²¹ See FAQ 12 on the FSA’s website at:

http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

²² See paragraph 1.9.2C E(4) of the Code.

²³ See paragraph 1.9.2D E(1) of the Code.

²⁴ See new definitions in the FSA Handbook glossary and FAQ 31 on the FSA’s website at:

http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

²⁵ See paragraph 1.9.2D E(2) of the Code.

²⁶ *Ibid.*

²⁷ See http://www.fsa.gov.uk/pubs/other/Form_TR4.pdf.

²⁸ See FAQ 35 on the FSA’s website at:

http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

²⁹ See FAQ 36 on the FSA’s website at:

http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

³⁰ See FAQ 40 on the FSA’s website at:

http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

³¹ See new definitions in the FSA Handbook glossary as inserted by the Short Selling (No. 3) Instrument.

Where a fund is managed on a discretionary basis and the individual fund is housed within a legal entity other than the fund manager, the disclosure obligation applies at the level of both the legal entity housing the fund and the fund manager. The fund manager can make a disclosure on behalf of the individual fund. The fund manager is required to disclose its aggregate short position across all of the funds it manages on a discretionary basis.³²

Temporary nature of the disclosure provisions

The disclosure provisions will cease to have effect on 16 January 2009, unless extended by the FSA.³³

Disclosure of certain short positions in rights issue situations

It should be noted that the Code also imposes certain disclosure requirements on holders of certain disclosable short positions relating to securities which are the subject of a rights issue (paragraph 1.9.2A E and rule 1.9.2B R of the Code). These were inserted into the Code earlier this year and may overlap with the new disclosure requirements.

4. Legality of the FSA's actions

There are reports in the press about possible challenges to the FSA's ban on short selling.³⁴ It is unlikely that any such challenge would succeed. The FSA clearly has the power to alter the provisions of the Code.³⁵ In justifying its response to short selling, the FSA could draw attention to the current market instability and the threat it poses to the achievement of its four regulatory objectives, in particular the objective of market confidence.³⁶ The fact that there has been a global response to short selling of stocks vulnerable to a collapse in prices lends further support to the FSA's actions.

³² See FAQ 11 on the FSA's website at: http://www.fsa.gov.uk/pubs/other/short_selling_faqs2.pdf.

³³ See paragraph 1.9.2D E(4) of the Code.

³⁴ See <http://www.telegraph.co.uk/finance/3046948/Hedge-funds-plan-to-sue-FSA-over-short-selling-ban.html>

³⁵ Section 119(4) of the Financial Services and Markets Act 2000.

³⁶ As specified by section 2 of the Financial Services and Markets Act 2000.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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