DechertOnPoint

June 2008 / Issue 9

A legal update from Dechert's Financial Services Group

# FSA Introduces Disclosure Regime for Short Positions

The Financial Services Authority (FSA) is pushing through a new disclosure requirement requiring all short-sellers to disclose net short positions in the shares of a company involved in a rights issue if the short is 0.25% or more of the market value of the company. This emergency measure appears to be an attempt to support UK banks' rights issues following severe volatility in the share prices, for which the FSA holds short-selling responsible. For example, during the recent HBOS rights issue priced at 275p, the company's share price fell 14% to 258p—less than the offer price.

The new short selling disclosure rule was announced on 13 June 2008 without any prior consultation and comes into force a week later on Friday, 20 June 2008.

The rule amends the Market Conduct sourcebook by inventing a new category of behaviour amounting to market abuse; namely:

| MAR 1.9.2A E |
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| Failure by a person to give adequate disclosure that he has reached or exceeded a disclosable short position where:<br>(i) that position relates, directly or indirectly, to securities which are the subject of a rights issue; and<br>(ii) the disclosable short position is reached or exceeded during a rights issue period;<br>is behaviour that, in the opinion of the FSAG, is market abuse (misleading behaviour). |

These obligations fall on the holder of a *disclosable short position* in relation to holdings after the relevant company has issued a formal notice via a Regulatory Information Service (RIS) of its intention to carry out a rights issue.

A *disclosable short position* covers any instrument which gives the holder a direct or indirect exposure to the shares of a company, including cash settled shares, CFDs, options (including those that cannot be exercised during the rights issue period) and other derivative instruments, of 0.25% of the issued capital of a company. Holdings in a company as part of a basket or index should be disregarded.

*Adequate disclosure* means disclosure by RIS announcement no later than 3.30 PM on the business day following the date on which the *disclosable short position* (0.25%) is reached or exceeded.

The RIS announcement must include the following information:

- Name of the person that has the *disclosable short position*;
- The *disclosable short position*;
- The name of the issuer of the qualifying instruments.

The disclosure requirement relates to companies whose shares are admitted to trading on a prescribed market (a market operated under the rules of a Regulated Investment Exchange or the Plus market). Although the use of pre-emptive methods of capital raising are more common in the UK, the disclosure rules will apply in the same way to companies constituted outside the UK.

Disclosure should be made on a net basis, to account for long positions in the company. However long positions in the rights under the rights issue and borrowed shares in the company cannot be used to net against short positions. Only the aggregate net short position is required

to be disclosed; a break down of the individual underlying positions is not required, nor is a breakdown of the underlying components (i.e., shares, options etc.).

If a short position of 0.25% is reached or exceeded, but is unwound before midnight on the same day, there will be no disclosure obligation.

The only exemption to the disclosure obligation is in relation to the holdings of market makers.

Where an asset manager holds short positions for discretionary clients, the obligation will be on the manager to make a disclosure. However, in the case of non-discretionary clients, the obligation will fall on the individual client. Asset managers mandated to manage more than one fund should aggregate the positions of all their discretionary funds for the purpose of determining whether they have a disclosable short position.

Although the FSA's actions have pleased listed companies trying to prop up their share prices, it has met with some incredulity among other market participants. The lack of any discussion or lead time marks a significant departure from the FSA's normal practice when introducing a significant new rule.

The requirement to publish the identity of the short seller seems verging on the punitive; while the categorisation of a failure to disclose as market abuse does not fit easily with the existing market abuse regime or the FSA's principles-based approach to regulation.

The requirements may have a particular impact on some of the larger hedge funds that often underwrite or sub-underwrite rights issues and hedge their positions by short selling. These funds are unlikely to want to hold exposed positions on shares and this may lead to a reduction in liquidity in the underwriting market. Insurance and investment firms that lend their shares to short sellers may also find this source of income reduced as a result of the market's reaction to the new disclosure requirements.

This update was written by Dick Frase (+44 20 7184 7692; richard.frase@dechert.com) and Michael Harwood-Smith (+44 20 7184 7869; michael.harwood-smith@dechert.com).

## Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/financialservices.

**Richard Frase**
London
+44 20 7184 7692
richard.frase@dechert.com

**Richard L. Heffner**
London
+44 20 7184 7665
richard.heffner@dechert.com

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