FSA Clarifies Disclosure Regime for Short Selling During Rights Issues

On 13 June 2008, the FSA announced that it was amending the Code of Market Conduct with effect from 20 June 2007 to require the disclosure of significant short positions in stocks admitted to trading on a prescribed market (which includes all the markets established under the rules of a UK recognised investment exchange, such as the London Stock Exchange). A position is a significant short position if it represents an economic interest of 0.25% of the issued share capital of a company.

This change has taken the market by surprise in two ways: first, the fact that the FSA should be proposing anything in this area; and second, that the proposal should have been brought in without any consultation, which gives firms very little time to amend their systems so as to comply. It is rare for the FSA to make changes without consultation with the market. The Financial Services and Market Act 2000 does allow the FSA to make changes to its rules without prior consultation, in circumstances where the FSA considers that the delay that would otherwise occur would be prejudicial to the interests of consumers. But the suspicion here is that it is not so much the interests of consumers that the FSA is concerned with, but rather the interests of those banks which are seeking to raise fresh capital by means of rights issues. It is perhaps no coincidence that the FSA announced the changes only a few days after the price of shares in HBOS fell below the price of its rights issue.

The FSA's press release indicates that the FSA views short selling as a legitimate technique, which assists liquidity and is not in itself abusive. This should give some comfort to firms that the FSA's move is not the first step in a general campaign to clamp down on short selling. But inevitably a move of this nature, without consultation, has left a number of questions open. The *Financial Times* of 17 June 2008 identified a number of such questions, and, later that day, the FSA published answers to what it termed "Frequently Asked Questions" ("FAQs") on the changes, in order to clarify the position. This list is not exhaustive, and may be updated in the future. The FAQs cover some, but not all, of the questions listed in the *Financial Times*. Among the points made are the following:

- the disclosure responsibility applies to all publicly listed companies in the UK, whether UK incorporated or not; companies with a primary listing elsewhere, and a secondary listing in the UK, are therefore covered, though the FSA envisages that the disclosure obligations will primarily relate to UK incorporated companies, given that the use of rights issues to raise capital is more common in the UK than elsewhere;

- the disclosure must be made by announcement to a Regulatory Information Service; FSA has provided a form for this purpose (available on the FSA website), though a different format may be used so long as the information required by the FSA form is provided;

- the calculation of the disclosable interest should be based on the percentage of the issued share capital as it stood before the rights issue;

- options should be included, even options that cannot be exercised during the rights issue period;

- the requirement to disclose applies to positions taken before the time the rights issue period commences, if they meet the 0.25% threshold once that period commences (though this seems hard to square with the amendment to the Code of market conduct, which requires the 0.25% position to be "reached or exceeded" during a rights issue period);

- there is no obligation to make further disclosures should the short position subsequently increase (though the FSA may consider the introduction of an incremental disclosure requirement if this appears to add value; and

- intra-day positions do not have to be disclosed; the key time for assessing whether disclosure is required is midnight on the day in question.

It remains to be seen whether the FSA's reputation for fair dealing with the industry will suffer lasting damage. To judge from the press release put out by the Alternative Investment Management Association, which mentioned its "disappointment" with the new provisions and its belief that the FSA has set an "awkward precedent", it would appear that the regulator may have some fence-mending to do. Rather ominously, the FSA press release refers to the fact that the FSA is "giving consideration" to taking other measures in this area, and that it is currently examining a number of options, including restricting the lending of stock in rights issues for the purposes of enabling short selling, and restricting short sellers from covering their positions by acquiring rights to the newly issued shares. One can only hope that the FSA will have learnt a lesson from the reaction the present proposal has engendered and allow the industry adequate time to respond to any further initiatives in this area.

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