



## Proposed UK Short Selling Rules

In the UK, the Financial Services Act 2010 (“FS Act”)<sup>1</sup> received Royal Assent on 8<sup>th</sup> April 2010, and will come into force on 8<sup>th</sup> June 2010.

The FS Act grants the UK Financial Services Authority (the “FSA”) enhanced powers to regulate short selling; these are inserted as a new Part 8A into the Financial Services and Markets Act 2000 (“FSMA 2000”), either by prohibiting it or by requiring disclosure of information.

At present, the FSA’s short selling rules are contained in the Code of Market Conduct (“MAR”)<sup>2</sup> implementing the market abuse provisions under Section 118(8)(a) of FSMA 2000. The FSA intends to use its new powers under the FS Act to replace the existing rules with a new FSA Handbook module: the Financial Stability and Market Confidence sourcebook (“FINMAR”).

Accordingly, the FSA launched on 26<sup>th</sup> April 2010 a public consultation<sup>3</sup> on the implementing aspects of the FS Act, *inter alia*, to invite feedback on its proposed short selling rules, particularly from authorised firms and unauthorised persons, whose business may impact on financial stability in the UK. The deadline for submission of comments is 25<sup>th</sup> June 2010.

The FSA proposes that the existing rules should be carried forward without substantive changes, except for a narrowing of the scope of companies to which the rights issue regime applies. A draft text of FINMAR is contained in Appendix 2 (Financial Stability and Market Confidence sourcebook Instrument 2010) of the consultation paper.

The FSA has stated that the proposals are subject to any overriding European Union (“EU”) legislation introducing a pan-European short selling regime, such as that proposed by the Committee of European Securities Regulators (“CESR”) on 2<sup>nd</sup> March 2010.<sup>4</sup>

<sup>1</sup> Financial Services Act 2010, [http://www.opsi.gov.uk/acts/acts2010/pdf/ukpga\\_20100028\\_en.pdf](http://www.opsi.gov.uk/acts/acts2010/pdf/ukpga_20100028_en.pdf).

<sup>2</sup> MAR 1.9, <http://fsahandbook.info/FSA/html/handbook/MAR/1/9>. See also, Short Selling (No. 5) Instrument 2009, [http://www.fsa.gov.uk/pubs/handbook/instrument\\_2009\\_1.pdf](http://www.fsa.gov.uk/pubs/handbook/instrument_2009_1.pdf) and Short Selling Instrument 2008, [http://www.fsa.gov.uk/pubs/press/PN0572008\\_instrument.pdf](http://www.fsa.gov.uk/pubs/press/PN0572008_instrument.pdf).

<sup>3</sup> FSA consultation paper (CP10/11): Implementing aspects of the Financial Services Act 2010 (26<sup>th</sup> April 2010), [http://www.fsa.gov.uk/pubs/cp/cp10\\_11.pdf](http://www.fsa.gov.uk/pubs/cp/cp10_11.pdf) (closing 25<sup>th</sup> June 2010).

<sup>4</sup> CESR report: Model for a Pan-European Short Selling Disclosure Regime (2<sup>nd</sup> March 2010), <http://www.cesr.eu/popup2.php?id=6487>. See also Morrison & Foerster client alert: CESR Proposals for a Pan-European Short Selling Regime (9<sup>th</sup> March 2010), <http://www.mofo.com/files/Uploads/Images/100409CESR.pdf>.

To summarise, the FSA proposes to implement the following short selling disclosure regime, whilst continuing to reserve the right to impose outright bans if justified by the market conditions:

### 1. Scope of the regimes

The FSA proposes to continue the two existing disclosure regimes, one relating to issuers undertaking a rights issue and the other relating to UK financial sector companies, until a permanent, EU-wide short selling regime is adopted.

- **UK financial sector companies regime:** No change is proposed to the present scope of the disclosure obligations affecting net positions in UK financial sector companies. This regime covers holders of net short positions in UK banks, UK insurers and UK incorporated parent undertakings of UK banks and UK insurers.
- **Rights issue companies regime:** In order to reduce the compliance burden, the FSA proposes to trim down the scope of the rights issue disclosure regime so that it will only apply to securities issued by non-UK companies, where a UK prescribed market is the main or sole venue for trading in the relevant securities.

### 2. Disclosure thresholds

The FSA does not propose to alter the existing thresholds for public disclosures of net short positions, in either UK financial sector companies (initial threshold of 0.25% and each subsequent change by a 0.1% increment) or rights issue companies (minimum threshold of 0.25%).

However, CESR has proposed a higher initial threshold of 0.5% for the EU-wide public disclosure regime, with further disclosures for incremental changes by 0.1%. In addition, CESR has proposed an EU private disclosure regime where disclosures must be made to relevant regulators at an initial threshold of 0.2%.

### 3. How to calculate net short positions

The FSA proposes to retain the methodology for calculating net short positions, as set out in its short selling FAQs.<sup>5</sup> Calculation of both the net short position and any changes, including for derivative instruments, must be on a delta-adjusted (rather than a notional) basis. All economic interests in the issued capital (and only the issued capital) of the company should be taken into account, including, without limitation, contracts for differences, spread bets and options. Intra-day positions need not be disclosed unless they reach any of the disclosure thresholds.

Any economic interest held as part of a basket, index or exchange-traded fund must also be taken into account when calculating a company's net short position, including any derivative products relating to an index.

During a rights issue period, special rules are applied in relation to nil paid rights:

- a person is not allowed to net a short position in the company's existing capital with a *long* position in the nil paid rights;
- however, a *short* position in the nil paid rights must be taken into account when calculating the overall net short position, as a significant short position in nil paid rights may impact on the price of the undiluted shares.

<sup>5</sup> Short Selling (No. 5) Instrument 2009 – FAQs Version 2 (issued 19<sup>th</sup> January 2009), [http://www.fsa.gov.uk/pubs/other/Short\\_selling\\_FAQs\\_V2.pdf](http://www.fsa.gov.uk/pubs/other/Short_selling_FAQs_V2.pdf).

#### 4. Netting

The FSA continues to believe that it is not appropriate to net positions at group level, where positions may be taken for entirely different reasons, such as long-term investments, short-term proprietary trading, or investment management.

Where one or more legal entities in a group structure is required to make a disclosure, positions should be netted (and disclosed) at each legal entity level separately. Where trading desks within a firm are housed in the same legal entity, the aggregate position of all such trading desks should apply, excluding any positions taken under the market maker exemption.

#### 5. Who is subject to the disclosure obligations?

The FSA's view remains that the disclosure obligation should apply to the holder of the net short position.

However, in relation to an investment manager or authorised fund manager acting on behalf of clients,

- if the management is on a non-discretionary basis, the disclosure obligation applies to the client (although the client can authorise the investment manager to make the necessary disclosure); and
- if the management is discretionary, then the disclosure obligation applies to both the client and the investment manager or authorised fund manager. The client must disclose (or authorise the investment manager to disclose) the client's net short position, and the investment manager must disclose its own aggregate net short position in respect of all portfolios managed by it.

Market makers will continue to be exempt from the disclosure obligations under the proposed new rules.

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