

Client Alert

A report
for clients
and friends
of the Firm 23 September 2008

On 18 September 2008 the UK Financial Services Authority (the “FSA”) announced:

On 18 September 2008, the UK Financial Services Authority (the “FSA”) announced:

- (a) an immediate ban on the active creation or increase of net short positions in the shares of publicly quoted UK financial sector companies (UK banks, UK insurers and their UK parents) as from 00.01 a.m. on 19 September 2008; and
- (b) a requirement for daily disclosure of all net short positions representing 0.25 per cent. or more of the issued equity capital of a financial sector company, the first such disclosure to be made by 3.30 p.m. on 23 September 2008 in relation to positions held on 19 and 22 September 2008.

While these requirements remain in force until 16 January 2009, FSA will review them after 30 days. FSA intends to publish a comprehensive review of the rules on short selling in January 2009.

The new provisions are contained in the FSA’s Short Selling (No. 2) Instrument 2008 (the “**Short-Selling Instrument**”) and were introduced by the FSA under its Market Conduct powers in an effort to stabilise the financial markets.

Contravention of the new provisions constitutes market abuse (under the misleading behaviour head) in respect of which the FSA may levy an unlimited fine or issue a public censure.

The US SEC announced similar measures at much the same time as the FSA.

The UK trade association for the hedge fund industry, the Alternative Investment Management Association, has called for an “early review of the efficacy of the short-selling bans and their consequences”.

Background to the new Market Conduct provisions

The FSA announcement to prohibit the short-selling of the shares of UK financial sector companies was made against the back-drop of the collapse of Lehman Brothers, the take-overs of Merrill Lynch and HBOS, and the precipitate fall in value of shares in other financial companies in the US and the UK. In announcing the FSA’s action, Hector Sants, the chief executive of the FSA, noted that the FSA still regards short-selling as “a legitimate investing technique in normal conditions”, before proceeding to state that the FSA had decided to take the unusual step of introducing a general prohibition on the short-selling of the shares of UK financial sector companies to “guard against further instability in the financial sector”. Mr. Sants has since made clear that the ban was triggered by fears of general market failure rather than market abuse.

The introduction of the Short-Selling Instrument represents the second set of provisions introduced by the FSA regulating short-selling in the last three months. The FSA previously introduced provisions that, with effect from 20 June 2008, required persons to disclose significant short positions in shares admitted to trading on UK prescribed markets where the issuer is undertaking a rights issue.

Only UK financial sector companies protected under the Short-Selling Instrument

The new provisions apply to a “UK financial sector company”, a term which is defined as a company which is a UK bank, UK insurer or its UK

incorporated parent undertaking. Initially the FSA released a list of 29 companies which were deemed to fall within the definition of a “UK financial sector company” for the purposes of the Short-Selling Instrument. This list was prepared on a “best endeavours basis” and has since been updated to include 32 companies. The following are not currently included: UK listed fund managers; ICAP Plc, the world’s largest broker of transactions between banks; and London Stock Exchange Group Plc.

The updated list of the 32 companies which come under the definition of a “UK financial sector company” for the purposes of the Short-Selling Instrument can be found on the FSA website: http://www.fsa.gov.uk/pubs/handbook/list_instrument200850.pdf. We would recommend that clients regularly check the FSA website for any new additions to the current list of UK financial sector companies as the FSA has made it clear that this list is subject to change.

New Prohibition of short-selling

The FSA has prohibited a person from entering into a transaction that, whether by itself or in conjunction with other transactions, has the effect of “creating a net short position in a UK financial sector company” or “increasing any net short position in a UK financial sector company that the person had immediately before 19 September 2008.” The prohibition applies to all transactions that create any net short position or increase any existing net short position.

Note that short positions existing before 19 September 2008 do not have to be closed, however, they cannot be actively increased. Also, a net short position which arises after 18 September 2008 and which is not a result of a new transaction being entered into will not be caught by the new prohibition. The FSA has also confirmed that uncovered short positions are within the ambit of the general prohibition and disclosure obligations set out in the Short-Selling Instrument. However, both existing and new net short positions may have to be disclosed if they are above the 0.25% threshold as a disclosable short position (see below).

A net short position is defined in the Short-Selling Instrument as “a net short position which gives rise to an economic exposure to the issued share capital of a company. Any calculation of whether a person has a short position must take account of any form of economic interest in the shares of the company.” FSA has given guidance that economic exposure means any instrument giving rise to an exposure, whether direct or indirect, in the equity share capital of a company. The equity share capital of a company includes securities like ordinary shares and convertible bonds, but does not include debt securities.

The FSA has confirmed that the short-selling prohibition covers intra-day trading, so a person cannot increase their net

short position intra-day despite the fact that the disclosable position held at the end of the day may not exceed the position disclosed at the start of the previous day. Furthermore, the new rules have a global reach and could cover the shorting of shares in one of the listed UK financial sector institutions traded on exchanges in other countries.

New disclosure requirement for short positions

The FSA also introduced new disclosure obligations for those persons holding a “disclosable short position”. In practice, market participants will need to have implemented compliance systems and controls which provide the means to calculate the level of positions held by them and have put in place structures to disclose this information to the market via a Regulatory Information Service (“RIS”). These systems and controls will need to be put in place on or before 23 September 2008.

A “disclosable short position” is defined as a “net short position which represents an economic interest of one quarter of one percent (0.25%) or more of the issued capital of a company”. The relevant denominator for calculating whether or not the 0.25% threshold has been reached is the entire issued share capital of the UK financial sector company. Importantly, only the aggregate net short position of 0.25% or above will need to be disclosed. There is no requirement to disclose any individual short and long positions underlying the net position, nor does an aggregated net short position need to be broken down into its constituent parts for the purposes of disclosure. If a person’s net short position falls below the 0.25% threshold, then that person is required to submit one final disclosure of that fact.

The FSA has defined “adequate ongoing disclosure” in the Short-Selling Instrument as disclosure made on a Regulatory Information Service or RIS by no later than 3:30pm on the business day following each day on which the disclosable short position is held. The Short-Selling Instrument states that ongoing adequate disclosure must include the following information in relation to the net short position:

- the name of the person who has the position;
- the amount of the position; and
- the name of the company in relation to which the person has that position.

The FSA recommends use of the TR4 Form which can be downloaded from the FSA website. http://www.fsa.gov.uk/pubs/other/Form_TR4.pdf. Any alternative format used to disclose the information must, at least, include all information required by the TR4 form. The required information should be disclosed using the RIS short code, SSD.

The first disclosure required under the new provisions in the Short-Selling Instrument must be made by 3:30pm on Tuesday, 23 September 2008 and this disclosure should relate to net short positions held both on Friday, 19 September 2008 and Monday, 22 September 2008. Thereafter, those holding net short positions will be expected to disclose their positions by 3:30pm on the business day following each day on which the disclosable short position is held. A disclosure is still required even if the size of the net short position has not changed.

Where a fund manager holds a disclosable short position on behalf of a client, to whom does the disclosure requirement apply?

For short positions held by fund managers on behalf of non-discretionary clients, the disclosure obligations apply to the client. For short positions held by fund managers on behalf of discretionary clients, the fund manager itself must make the disclosure. In the latter case, the client does not need to be named in the disclosure. Furthermore, where a fund manager that is a legal entity has a mandate to manage more than one individual fund, the FSA suggests that the fund manager should aggregate the positions of all its discretionary funds for the purposes of determining whether or not it has a disclosable short position. The FSA's rationale for this is that the person who exercises control over holdings of economic interests in a UK financial sector company should be required to disclose that fact.

Market makers are exempted

Only market makers are exempt from the new disclosure and prohibition rules. The FSA has defined a market maker, for these purposes only, as an entity which "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."

Possibility of further FSA Action

The FSA has reserved the right to extend the prohibition on the short-selling of the stock of publicly quoted financial institutions to other areas if it considers this to be "necessary". The FSA plans to publish a comprehensive review of the rules on short-selling in January 2009.

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Proskauer's Corporate Department includes over 175 attorneys worldwide with significant and diverse corporate law experience.

For more information, please contact:

Matthew D.J. Hudson, London
+44.(0).20.7016.3601 – mhudson@proskauer.com

William Yonge, London
+44.(0).20.7016.3680 – wyonge@proskauer.com

Christopher M. Wells, New York
+1.212.969.3600 – cwells@proskauer.com

Timothy M. Clark, New York
+1.212.969.3960 – tclark@proskauer.com

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