



## UK's New Short-Selling Prohibition

On 18 September 2008, amidst worsening market turmoil following the recent bankruptcy filing of Lehman Brothers, the US government bail-out of AIG, and the impending rescue takeover of the UK's largest mortgage lender HBOS by Lloyds TSB, the UK's Financial Services Authority (FSA) announced<sup>1</sup> an emergency ban on all short-selling in publicly quoted UK financial sector companies<sup>2</sup> (*i.e.*, UK banks or insurers, or their UK-incorporated parent companies) in effect from midnight on 18 September 2008.

Whilst still regarding short-selling as "a legitimate investment technique in normal market conditions," the FSA has determined that the current "extreme circumstances" necessitate the ban and a heightened disclosure obligation in order to forestall any further instability and loss of confidence in the financial sector.

### Background

"Short-selling" refers to an investment technique whereby the investor agrees to sell shares in the future at a pre-agreed price, betting that the share price will fall, which would then allow him to buy the shares at a lower price when he actually delivers them to the buyer and to pocket the difference. In most cases, the short seller will have a "covered" short position, *i.e.*, he will have borrowed the underlying shares at the time he entered into the sale, in order to ensure that he can fulfil his obligation to deliver the shares.

Recent sharp falls in the share prices of HBOS (as well as those of Lehman Brothers and AIG) have been blamed on the spreading of malicious rumours designed to drive share prices down, and since short-sellers are the parties who most obviously gain from falls in share prices, this has stirred up a degree of political backlash against short-selling and hedge funds and other institutional traders who typically employ these techniques (whether legitimately or otherwise).

Certain politicians and investors have recently called for greater regulation and transparency of short-selling, particularly in bank shares, in view of the fact that the stability of retail savings banks and other financial institutions is critical to maintaining (or restoring) confidence in the overall financial system.

On 17 September 2008, the US Securities and Exchange Commission (SEC) strengthened its own rules against abusive "naked short-selling," which refers to a fraudulent practice of short-selling where the seller does not have the intention or the ability to deliver the shares.<sup>3</sup> On 19 September 2008, the SEC launched an emergency

<sup>1</sup> FSA statement on short positions in financial stocks (FSA/PN/102/2008), dated 18 September 2008, <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml>.

<sup>2</sup> List of UK incorporated banks and insurers in connection with Short Selling (No. 2) Instrument 2008, [http://www.fsa.gov.uk/pubs/handbook/list\\_instrument200850.pdf](http://www.fsa.gov.uk/pubs/handbook/list_instrument200850.pdf).

<sup>3</sup> See Morrison & Foerster News Bulletin entitled "SEC Takes Emergency Action on Shorting; South Dakota Short-selling Ballot Initiative" (17 September 2008), <http://www.mofo.com/news/updates/files/080917ShortSell.pdf>.

temporary ban on covered short-selling in 799 financial company shares in a move similar to the FSA's latest action.

### FSA's new short-selling rules

The new UK rules are introduced by the Short Selling (No. 2) Instrument 2008<sup>4</sup> amending the FSA's Code of Market Conduct and constitute a complete ban on creating or adding to any net short positions in UK financial sector companies, although existing short positions need not be closed.

Furthermore, from 23 September 2008, short-sellers in the relevant companies will be required to make daily disclosures of "disclosable short positions," *i.e.*, any "net short positions" held by them representing 0.25% or more of the issued capital of a relevant company held at market close on the previous day. The first disclosure (which must be made by 3.30 p.m. on 23 September 2008) will apply to any such positions held on 19 September as well as those held on 22 September.

For this purpose, "net short position" includes any form of economic exposure, direct or indirect, to the company's shares (but excluding shares held in a market-maker<sup>5</sup> capacity). Therefore, the calculation must take account of short positions under options and other derivative instruments referencing the shares (such as contracts for difference, equity swaps and equity-linked notes) as well as in physical shares.

The short-seller must make the requisite disclosure on a Regulatory Information Service (RIS) on every business day by no later than 3.30 p.m., and must include the amount of the net short position, the date when it was held and the names of the short-seller and the issuer company.<sup>6</sup> Disclosure is required, even if the short position has not changed from the previous day's reported position.

Failure to make such disclosure will amount to "market abuse" (as a "misleading behaviour") under the Financial Services and Markets Act 2000.

At first glance, the ongoing disclosure obligation appears odd, due to the outright ban on creating new short positions in the relevant companies after midnight on 18 September 2008. However, the reason for this is that a person may have had a disclosable short position before 19 September 2008 or alternatively may have had a non-disclosable short position before that date which, due to extraneous factors, becomes a disclosable short position.

The new rules will initially remain in force until 16 January 2009, although the FSA will review them after 30 days and publish a comprehensive review of the rules on short-selling in January 2009.

### Previous FSA action

In June 2008, the FSA surprised the markets by imposing emergency disclosure rules as to the short-selling of the UK-listed shares of any company (whether in the financial sector or otherwise) during a rights issue of that company, after plunging share prices threatened to sabotage HBOS's rights issue at the time.<sup>7</sup> These rules required short-sellers to disclose any net short position representing an economic interest of 0.25% in such shares. Those disclosure rules remain in effect and run parallel with those contained in the Short Selling (No. 2)

<sup>4</sup> Short Selling (No. 2) Instrument 2008, [http://www.fsa.gov.uk/pubs/handbook/instrument2\\_2008\\_50.pdf](http://www.fsa.gov.uk/pubs/handbook/instrument2_2008_50.pdf); Short Selling (No 2) Instrument 2008, with highlighted changes, [http://www.fsa.gov.uk/pubs/handbook/instrument\\_2008\\_50.pdf](http://www.fsa.gov.uk/pubs/handbook/instrument_2008_50.pdf).

<sup>5</sup> A "market-maker" is defined as "an entity ordinarily as part of their business dealing as principal in equities, options or derivatives (whether OTC or exchange-traded) to fulfill orders received from clients, to respond to a client's requests to trade or to hedge positions arising out of those dealings."

<sup>6</sup> Form TR-4: Disclosure of Short Positions relating to UK Financial Sector Company (Version 1.0 September 2008), [http://www.fsa.gov.uk/pubs/other/Form\\_TR4.pdf](http://www.fsa.gov.uk/pubs/other/Form_TR4.pdf).

<sup>7</sup> See Morrison & Foerster News Bulletin entitled "Heightened Derivatives and Trading Disclosure for UK Equity Markets" (9 July 2008), <http://www.mofo.com/news/updates/files/080917ShortSell.pdf>.

Instrument 2008, although there is a substantial overlap between the two sets of rules in respect of UK financial institutions.

## Outlook

The FSA has indicated that they will be keeping the rules under review and will introduce further measures as necessary, including the possible extension to shares in non-financial sector companies.

The rules in their current form may, therefore, be temporary and market participants may well have an opportunity to express their views on the matter when FSA publishes a comprehensive review of all the short-selling rules in January 2009. However, any possibility of the ban being lifted or the disclosure requirements being relaxed is likely to depend on the state of the financial markets and the corresponding regulatory approach at that time.

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