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UK Prohibition on the Short Selling of Financial Stocks

BY RONAN O'SULLIVAN AND SERGIO WEINGARTEN

On September 19, 2008 (the "**Implementation Date**"), the Financial Services Authority (the "**FSA**") the competent authority for regulating financial services in the UK, introduced the Short Selling (No. 2) Instrument 2008 which amended the Code of Market Conduct for market participants in the UK (the "**Rules**"). These Rules immediately prohibited the creation or addition to net short positions in the UK's financial sector companies until midnight on January 16, 2009. In addition to the absolute prohibition, there are also new disclosure requirements that cover short positions which were pre-existing before the Implementation Date.

THE GENERAL PROHIBITION

The Rules contain a general prohibition under which any person who enters into a transaction that has the effect of increasing a net short position held immediately before the Implementation Date or creating a net short position in a UK financial sector company will be considered to have engaged in behavior that amounts to market abuse.

The FSA has published a non-exhaustive list of financial sector companies on its website which includes UK banks and UK insurers who are subject to the Rules (available at http://ww.fsa.gov.uk/pubs/handbook/list_instrument 200850.pdf).

Taking a 'net short position' in a company is viewed as being any position which "*gives rise to an economic exposure to the issued share capital of a company.*"[1] In practice, it seems that the FSA will view this as being applicable to any instrument (not merely a direct equity position) which gives rise to an exposure, whether direct or indirect, in the equity share capital of a company, for example, the FSA has indicated that economic interests held as part of a basket of shares or a share index where all components of the basket or index are UK financial sector companies would be included when determining economic exposure.[2]

DISCLOSURE REQUIREMENTS

The general prohibition does not apply to a person whose position prior to the Implementation Date subsequently moves to become a net short position. In this situation if the person holds a net short position of 0.25% or more of the entire issued share capital of a financial sector company then they must disclose this. A failure to disclose in such a situation will be treated as market abuse by the FSA as part of the FSA's authority under the Financial Services and Markets Act 2000 ("**FSMA**").

The first disclosure deadline was 3:30pm on Tuesday September 23, 2008 and related to any net short position of 0.25% or above held at the end of the Implementation Date, or Monday September 22, 2008 if different. Subsequently to this, a person will have to disclose any net short position of 0.25% or above by 3:30pm on the day following each day that this position is held.

The disclosure itself must be made using a TR4 form (available at www.fsa.gov.uk) via an announcement through a Regulatory Information Service (RIS). It should be noted that where more than one legal entity with a disclosable short position exists within a group, a disclosure must be made by each of those different entities.

EXEMPTIONS

Market makers are exempt from the Rules on short selling. For the purposes of the Rules, the FSA has defined a market maker as follows:

"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."[3]

The FSA has also confirmed that the prohibition does not apply to the issuers of convertible bonds or to stock lending.

CONSEQUENCES OF NON-COMPLIANCE

A failure to comply with either the general prohibition or the disclosure provisions will be treated as misleading behavior and will therefore amount to market abuse. Under FSMA the FSA has the authority to impose an enforcement action, an unlimited fine and public censure.

THE FUTURE

The Rules will be reviewed after 30 days but at present will remain in place until January 16, 2009. The measure taken by the FSA is unprecedented and it will be interesting to note how market participants respond to the prohibition, particularly in the light of liquidity concerns. It is too early to say whether this will lead to an outright prohibition on short selling in the UK although some commentators have suggested that this may be the case.

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Please note that this article does not serve to act as an exhaustive overview of the Rules. If you have any questions concerning the issues raised in this article then please do not hesitate to contact any of the following Paul Hastings lawyers:

London
Ronan O'Sullivan
44-20-3023-5127
ronanosullivan@paulhastings.com

Sergio Weingarten
44-20-3023-5175
sergioweingarten@paulhastings.com

[1] Annex A, Short Selling (No.2) Instrument 2008

[2] FSA FAQ's on the Short Selling (No.2) Instrument 2008

[3] FSA FAQ's on the Short Selling (NO.2) Instrument 2008