

# 149

Financial Services Authority

**Market abuse:**

**Pre-hedging convertible and  
exchangeable bond issues**

July 2002



# Contents

1	Executive summary	3
2	Introduction	6
3	Market Practices Regarding Convertible/Exchangeable Bonds	8
4	Application of Market Abuse Regime to Convertible/Exchangeable Bonds	13
5	The Standards Expected by the Reasonable Regular User	19
6	Conclusions	22
	<b>Annex A:</b> Draft Guidance Text	
	<b>Annex B:</b> Extracts from UK Listing Rules	
	<b>Annex C:</b> Summary of Questions	
	<b>Annex D:</b> Cost Benefit Analysis	
	<b>Annex E:</b> Compatibility with the FSA's General Duties	

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 31 October 2002. You can send your response by electronic submission using the form on the FSA's website (at [www.fsa.gov.uk/pubs/cp/cp149\\_response.html](http://www.fsa.gov.uk/pubs/cp/cp149_response.html)), by e-mail or in writing to the following:

Fionnuala O'Brien  
Markets and Exchanges Division  
6th Floor  
The Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

Telephone: 020 7676 5904  
Fax: 020 7676 5905  
E-mail: [cp149@fsa.gov.uk](mailto:cp149@fsa.gov.uk)

**It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.**

# 1 Executive summary

## Context

- 1.1 The market for convertible bonds and exchangeable bonds<sup>1</sup> has grown rapidly in the past two years, with many companies now choosing to raise capital or transfer large shareholdings through these means. In 2001, issues of convertible and exchangeable bonds (“convertible/exchangeable bonds”) in the UK are estimated to have been capitalised at €29.52 billion with issue proceeds amounting to €6.01 billion<sup>2</sup>. Purchasers of the bonds are primarily professional market counter-parties; predominantly proprietary desks of large investment banks, hedge funds and investment managers.
- 1.2 On the issuance of a convertible/exchangeable bond, the underlying shares into which the bond may be converted can become volatile, with the price being discounted by between 3% and 5% in the short term. Therefore, those issuing or buying such bonds have a desire to hedge their position by selling short the equity, covering the short equity position through borrowing shares or entering into a derivative. There is currently a variety of practices and differing opinions within the market regarding the extent to which hedging can occur before the disclosure of the launch of the convertible/exchangeable bond (pre-hedging).
- 1.3 With the coming into force of the new market abuse regime, we have been asked by several market practitioners to clarify what pre-hedging practices we consider are acceptable under the Code of Market Conduct (‘the Code’) and to identify which, if any, might amount to market abuse. Given the present diversity of opinion among market practitioners, the growing importance of the convertible/exchangeable bond market and the number of potential requests for guidance on this subject from individual firms, we consider that this issue warrants general guidance under section 157 of the Financial Services and Markets Act. The guidance would take the form of an addition

---

1 Convertible bonds are issued by a company for the purpose of raising capital and are convertible into the company's own shares. Exchangeable bonds are issued by a company or a firm and are convertible into the shares of a third party. The issuer normally has a long position in the shares into which the bond can be converted and is using the exchangeable bond to dispose of a substantial shareholding or cross shareholding.

2 Dresdner Kleinwort Wasserstein Research estimates

to the annex to the Code on specialist topics. We do not anticipate adding a large number of specialist topics in the future as we consider the number of issues where further specialist guidance is required is limited.

### **Objective**

- 1.4 This paper therefore sets out the FSA's views on what the regular user is likely to consider as acceptable pre-hedging practices for convertible/exchangeable bonds under the market abuse regime. It includes draft guidance which we propose to issue on this subject and invites comments from interested parties.

### **Consumers**

- 1.5 **This paper will not be of primary interest to retail consumers, as it only affects those hedging convertible/exchangeable bonds.**

### **Synopsis**

- 1.6 The guidance we propose to issue is that the regular user is likely to consider that, for convertible/exchangeable bonds whose launch is required to be disclosed to the market, no dealing or arranging in the underlying shares would be acceptable before the disclosure is made. However, informal arrangements to locate and have right of first refusal over shares from prospective lenders ('icing') would, if informal, be likely to be considered acceptable by the regular user, provided that the icing is commercially reasonable to facilitate the potential stock loan as a hedge and does not involve contractual agreements (see 3.11 for a more detailed description of icing). Entering into credit protection in respect of the issue of a convertible/exchangeable bond prior to launch may in some circumstances also be regarded by the regular user as acceptable if the credit default terms are not linked to a qualifying investment.
- 1.7 The rationale for suggesting that these would be the views of the regular user is that short selling or borrowing of the underlying shares in advance of the disclosure of the launch would amount to misuse of information. However, icing, if done via an informal, non-binding arrangement rather than a contractual 'pay to hold' agreement, would not be considered to cause any appreciable market disadvantage to others. This position would, of course, need to be reviewed should market practice change and icing arrangements become more formal.
- 1.8 For convertible/exchangeable bonds where there is no disclosure obligation the regular user is likely to consider that dealing or arranging in the underlying security is acceptable prior to the disclosure of the launch of the issue.

## **Map**

1.9 The rest of the paper is structured as follows:

Chapter 2 is the introduction, which provides the background to why we consider that guidance in this area is necessary and what the purpose of this paper is.

Chapter 3 sets out information on types of convertible/exchangeable bond structures and current market practice in this area.

Chapter 4 outlines the scope of the market abuse regime and provides an analysis of how the Code might apply to behaviour in the convertible/exchangeable bond market.

Chapter 5 discusses our view of what the regular user would or would not be likely to regard as acceptable behaviour in this area.

Chapter 6 gives our conclusions.

Annex A is a draft of the guidance which we propose should be added to the specialist topics annex to the Code on this issue.

Annex B contains relevant extracts from the UK listing rules regarding disclosure requirements.

Annex C lists the questions we would like respondents to this paper to focus on.

Annex D is a Cost Benefit Analysis of the proposed guidance.

Annex E is a statement of why we consider the proposed guidance is compatible with the FSA's general duties.

## **Next steps**

1.10 Following the consultation exercise, we will produce a policy statement and formally issue general guidance on this subject.

# 2 Introduction

- 2.1 The Financial Services and Markets Act 2000 (the Act) states that the purpose of the Code is to give appropriate guidance to those deciding whether behaviour amounts to market abuse, as defined in Section 118 of the Act (Market abuse). The Code aims to give as much clarity and certainty as it can about behaviour that is likely to be considered to be market abuse. However, the Code is not exhaustive in its descriptions of such behaviour. When circumstances warrant it, the FSA is prepared to issue general guidance regarding its opinion of what behaviour the regular user is or is not likely to consider acceptable.
- 2.2 The hedging practices in advance of the launch of convertible/exchangeable bonds is one such area. The markets for convertible/exchangeable bonds have been growing rapidly over the past few years and these bonds are now a very popular financial instrument, both as an issuing vehicle and as an investment opportunity. As with any new and developing market, there is a variety of practice and some divergence of view as to what is and what is not acceptable behaviour in this area.
- 2.3 Issues of convertible/exchangeable bonds fall within the scope of the market abuse regime if:
  - (a) the issuer is a company whose equity securities trade on a market prescribed by the Treasury as one to which the market abuse regime applies ('prescribed market'); or
  - (b) the underlying equity that the exchangeable bond converts into is traded on a prescribed market; or
  - (c) the convertible/exchangeable bond is itself traded on a prescribed market.

Many European equities underlying convertible and exchangeable bonds are traded on the London Stock Exchange's SEAQ I and/or virt-x, both of which are prescribed markets, and therefore fall within the scope of the market abuse regime.

- 2.4 We have received requests from market participants for guidance on acceptable practices in relation to the issuance of convertible/exchangeable bonds. Specifically, we have been asked whether it is acceptable for the lead manager/underwriter to enter into certain transactions to hedge a new issue of a convertible/exchangeable bond in advance of that issue being disclosed to the market. The knowledge that a new issue is going to be launched is information which could be misused. So, if a person trades ahead of other market participants to take advantage of that information, the behaviour may fall below the standards expected by the regular user.
- 2.5 Consequently, we have decided to issue draft guidance for consultation on how the regular user would be likely to regard these different hedging practices and strategies. This will enable us to issue general guidance to market participants on whether certain practices are likely to be regarded by the regular user as amounting to market abuse.
- 2.6 This paper sets out the main issues arising from the behaviour, presents our preliminary conclusions and sets out draft guidance we would propose to issue. This paper does not consider the position of the hedging practices under the Criminal Justice Act 1993 (Insider Dealing). However, market practitioners will need to give careful consideration to those provisions.

# 3 Market practices regarding convertible/exchangeable bonds

## Types of convertibles

- 3.1 There are many different types of convertible/exchangeable bond structures.<sup>3</sup> These bonds do not fit into neatly defined boxes. However, the two main types of products are:
- **convertible bonds** that are issued by a company for the purpose of raising capital and are convertible into the company's own shares. The company issues new shares in time for the conversion. Invariably the new shares will be fungible with the existing shares already traded on a prescribed market.
  - **exchangeable bonds** that are issued by a company or firm which are convertible into a third party's shares. In this case, the issuer normally has a long position in the underlying shares and is disposing of a substantial shareholding or cross shareholding.
- 3.2 Market sources and the new issues pages on Bloomberg and Reuters indicate that currently in the UK the vast majority of such issues are exchangeable bonds. This is because few UK companies currently choose to raise capital through the issuance of convertible bonds.

## Marketing practices

- 3.3 It appears that although there are many different types of these bonds, most of them are in fact marketed and packaged in the same way, regardless of whether they are issued by a company for the purpose of raising capital or to dispose of a cross shareholding. The marketing of these products is very

---

3 A convertible bond is a structured product comprising a debt instrument with an embedded potential equity return. It is often referred to as equity linked debt. The convertible bond may pay a coupon. The equity component permits the holder of the convertible bond to elect, at a date in the future, whether to take delivery of the underlying equity. If the holder does not exercise the right to convert the bond, then the bonds are generally redeemed at par. The convertible bond sometimes gives the issuer the right to call the bonds before the maturity date if the underlying equity trades above a certain price for a given period of time. The equity component is similar, if not identical, economically to an OTC call option on the underlying equity for the buyer of the convertible bond which means the holder is synthetically long a call option on the equity.

similar to that for eurobonds. This means that they are structured as a primary market product and are subject to an official launch.

- 3.4 The sales force is typically informed for the first time about the deal between 7 am and 7.30am on the morning of the launch of the issue. They then forward the term sheets (as part of an invitation telex) to their clients simultaneously by e-mail or Bloomberg's messaging system, and the terms of the convertible/exchangeable bond very quickly become known to other professional market participants. Typically the professional market is aware that a convertible/exchangeable bond is being launched before the UK equity markets open at 8 am.
- 3.5 The deal is often closed the same day, although the book building exercise can last for a few days. After the book is closed, the convertible/exchangeable bond is priced and the allocation of the bonds occurs overnight. If the convertible/exchangeable bond is going to be listed, it often trades in the 'grey market' before it is listed or admitted to trading.
- 3.6 Sometimes the manager/issuer for the convertible/exchangeable bond announces the launch of the issue to the market via specific pages on Bloomberg or Reuters. The key terms of the convertible/exchangeable bond are normally accessible through these pages. However, we are told that the terms that are detailed on Bloomberg or Reuter's pages are not always posted by the issuer or an interested party, but occasionally, by a third party who is reporting what he has heard in the market place. It has been suggested to us that for this reason the terms on these pages are not always accurate.
- 3.7 Other deals are sold privately and may or may not be the subject of any disclosure. The investment bankers of a firm will approach potential customers on a confidential basis to assess whether they wish to participate in the placement of the issue. The convertible/exchangeable bonds are all placed before any disclosure is made to the market. If there is a disclosure, it may inform the market of the terms of the convertible/exchangeable bond and/or the fact that the deal was privately placed.

### **Current hedging strategies**

- 3.8 We understand that some investment banks or underwriters who manage new issues 'pre-hedge' the issuance of the convertible/exchangeable bond to manage the potential exposure they may have if the issue is not fully sold – the hedge is put in place before the launch of the issue is disclosed. Alternatively, the managers of an issue may offer to sell the convertible/exchangeable bond as a package to their counterparties (typically hedge funds). This package may include a credit derivative in relation to the issuer's credit worthiness, a sale of the underlying shares (short sale) and a stock borrowing to cover the short sale.

This investment package is attractive to buyers because it comes pre-hedged with all the inherent costs built into the pricing.

- 3.9 It should be noted that speculative activity might also occur when other market participants trade on rumours circulating in the market that a new issue may be launched. We have been told this frequently happens. This activity cannot be characterised as hedging as the activity is purely speculative. There is a significant difference in the behaviour, under section 118 of the Act and the Code, where someone is trading based on rumours as opposed to trading based on actual information. This is discussed further in the section on relevant information in Chapter 4 of this paper.
- 3.10 We have identified the following hedging strategies. Underwriters may decide to do one or more of the following:
- a) sell the underlying shares short or enter into a derivatives transaction to sell the shares (by replicating the economics of a short sale);
  - b) borrow the underlying shares to cover the short sale or in anticipation of entering into a short sale;
  - c) ‘ice’ the underlying shares in order to borrow the shares to cover any short sale. The purpose of icing is to locate shares in case they are needed for borrowing after the short sale is executed;
  - d) hedge the credit risk associated with an issue, the underwriter/lead manager may also purchase credit protection through a credit derivative.
- Q3.1 Are you aware of any hedging practices other than the ones we have identified? If yes, what are they?

### **Icing**

- 3.11 In general terms, when we refer to ‘informal icing’ in this paper we refer to non-binding arrangements as distinct from a formal reservation or borrowing of shares. The practice currently involves a person locating shares that are available for borrowing and asking the lender for the right of first refusal over the shares. This type of icing is subject to challenge by a third party who wants to borrow the shares from the same lender. In these circumstances the firm which originally ices the shares has the right of first refusal, but is obliged when the icing is challenged by a third party either to borrow the shares or lose the iced shares in whole or in part. The terms of the icing can be agreed in advance, but normally looser arrangements are put in place. Typically, the parties agree how many shares are subject to the icing, but this is subject to alteration once the convertible/exchangeable bond is launched. The number of shares subsequently loaned may be smaller than the number of shares on ice if the demand for the shares is strong. In these circumstances, the lender allocates the shares amongst those wishing to borrow them, not just

the original party requesting the icing. For this reason some people will ice shares with several lenders to ensure that they get their desired allocation. Either party can cancel the arrangement before they agree to the terms of the stock loan. If the potential borrower decides to borrow the shares, it is at this stage that the stock loan is drawn down and terms are finalised.

- 3.12 Some arrangements for locating shares differ from those described above in that they may create contractual obligations between the parties. Sometimes a fee may be paid to guarantee the number of shares to be reserved. These are commonly known as ‘pay to hold’ arrangements. We would distinguish between such arrangements and the informal icing as described in paragraph 3.11, because in the case of ‘pay to hold’ arrangements the shares are no longer available to other market participants. It is the prospective borrower and not the lender who controls whether the shares can be released from this arrangement or borrowed in due course.

### **Market views on these hedging practices**

- 3.13 As regards the different types of hedging activities, the majority (though by no means all) of firms we have spoken to do not consider that selling the shares short or borrowing the shares are acceptable behaviour prior to the disclosure to the market that an issue is being launched. But views are more divided on icing which is not perceived as having the same market impact as an outright sale or borrow. It would seem that the opinions are influenced by legal analysis the firms have received under the Criminal Justice Act and not necessarily just their interpretation of what is unacceptable under the Code.
- 3.14 There are broadly two conflicting bodies of opinion among market participants on icing. One group believes that icing is acceptable prior to the launch of the convertible/exchangeable bond. The reasons given were that icing arrangements are not contractual, as they can be amended post launch. They also consider that, as icing serves to locate the shares, it assists with the price formation of the convertible/exchangeable bond. Also, some consider it would be unreasonable to deny the lead manager the ability to ice the shares as a hedge when third parties may ice the shares on the basis of rumours. This is seen to place the lead manager at a disadvantage to other market participants, especially if they have ‘bought’ the deal<sup>4</sup> and are at risk on the unsold part of the issue. They argue that icing should be allowed before the disclosure of the launch of the bond. However, these market participants believe that the number of shares ‘iced’ should be objectively assessed based on the requirement to be able to hedge a convertible/exchangeable bond in a commercially reasonable manner.

---

4 A ‘bought deal’ is where an issuer asks a few investment banks to bid in an auction process for the whole of the convertible or exchangeable bond which they want to issue. The auction is private and the investment banks are normally subject to confidentiality undertakings. The successful bidder then takes the whole of the issue onto its own books as its position and sells the issue to the market.

3.15 Other practitioners believe that icing is unacceptable prior to the launch of the convertible/exchangeable bond. The reasons given were that there is a formal commitment underlying icing even if no ‘pay to hold’ agreement is involved because in their view lenders consider themselves bound to allocate shares to the firms who have iced the shares, even if the number of shares is reduced and the terms are only agreed post disclosure. Icing subject to challenge is encouraged under the Stock Borrowing and Lending Code<sup>5</sup> and market practitioners expect each other to observe this market code as good market practice. It is also argued that as icing is only one part of the overall hedging strategy, it would be illogical to continue to allow it to take place if the other hedging elements amount to market abuse. Although this group argue that price discovery is important when pricing a convertible/exchangeable bond, they believe it can occur by taking potential hedge counterparties over the Chinese wall and subjecting them to confidentiality undertakings. This allows discussion of the market’s appetite for the new issue and pricing. Breach of these confidentiality undertakings by recipients of the information could potentially amount to market abuse.

Q3.2 What are your views on the acceptability, or otherwise, of the behaviour outlined above (selling, borrowing and icing) before the launch of an issue is disclosed to the market?

Q3.3 Do you consider that a distinction can be drawn between informal icing arrangements and “pay to hold” agreements? In particular is it the case for informal icing arrangements that lenders are paid a premium when the shares are taken up or borrowed after the offer is announced, which essentially compensates the lender in a manner that is economically equivalent to a “pay to hold” agreement?

Q3.4 Are the standards regarding the behaviour of an underwriter different in this area? If so, why?

---

5 Published by the Stock Lending and Repo Committee on the 1st January 2001.

# 4 Application of the market abuse regime to convertible/exchangeable bonds

4.1 This chapter discusses which convertible/exchangeable bonds and associated products will come within the scope of the market abuse regime and the factors that need to be present to meet the misuse of information condition set out in the Code. Chapter 5 then goes on to discuss how we consider the regular user would view the practices and the reasons why we consider they would reach this view.

## **Which bonds fall within the market abuse regime?**

4.2 Several criteria are required to be met for behaviour to fall within the scope of the market abuse regime.

4.3 Under section 118(1)(a) of the Act behaviour must occur in relation to a qualifying investment traded on a prescribed market. The Treasury, in orders made pursuant to section 118(3) of the Act, has prescribed all markets established under the rules of a UK Recognised Investment Exchange and OFEX – see MAR 1.11.2G. The Treasury has also prescribed as qualifying investments in relation to those markets, the investments specified in articles 74 to 89 of the Regulated Activities Order.

4.4 According to section 118(6) of the Act “behaviour which is to be regarded as occurring in relation to qualifying investments includes behaviour which:

- a) occurs in relation to anything which is the subject matter, or whose price or value is expressed by reference to the price or value, of those qualifying investments: or
- b) occurs in relation to investments (whether qualifying or not) whose subject matter is those qualifying investments.”

4.5 Lastly, in accordance with section 118(6) of the Act and as explained in the guidance given at MAR 1.11.6E, behaviour can occur in relation to a qualifying investment traded on a prescribed market if the behaviour is in relation to other investments which are not themselves traded on a prescribed

market. This is because such behaviour can have a damaging effect on prescribed markets. These products are referred to in the Code as relevant products. For a definition of these please see MAR 1.11.9E.

- 4.6 Consequently, for section 118(1)(a) and the Code to apply to a convertible/exchangeable bond it is necessary that:
- the issuer is a company whose shares trade on a prescribed market; or
  - the underlying equity is to be traded on a prescribed market and therefore the convertible or exchangeable bond is a relevant product; or
  - the convertible/exchangeable bond is itself traded on a prescribed market.

#### **Application to credit derivatives purchased in association with a convertible/exchangeable bond**

- 4.7 ‘Credit derivative’ is a generic term used for many different types of financial instrument whose payments may be referenced to an entity or certain financial defaults. They are bilateral arrangements and are all specifically tailored to the parties’ needs. If the default provisions of the credit derivative relating to the credit worthiness of the issuer of a convertible/exchangeable bond are linked to a qualifying investment in the manner described at MAR 1.11.9E, then the credit derivative will be considered to be a relevant product and so fall within the scope of the market abuse regime.

#### **What behaviour will fall within the scope of the misuse of information prohibition of the market abuse regime?**

- 4.8 Under section 118(1)(b) of the Act, one or more of the conditions in section 118(2) have to be met in order for behaviour to amount to market abuse (see MAR 1.1.3G). MAR 1.4.4E discusses the condition in section 118(2)(a) of the Act (misuse of information). Under MAR 1.4.4E four factors need to be present for the use of the information to be restricted:
- the behaviour, and specifically the dealing or arranging, has to be based on the information, see MAR 1.4.4E(1);
  - the information must not be generally available, see MAR 1.4.4E(2);
  - the information must be likely to be regarded by the regular user as relevant when deciding on the terms of the transaction, MAR 1.4.4E(3);
  - the information must relate to matters which the regular user would reasonably expect to be disclosed to users of the market, see MAR 1.4.4E(4). In an attempt to add some clarity on the types of information under consideration the Code breaks this down into two types of information at MAR 1.4.12E(1) discloseable information and (2) announceable information.

- 4.9 An analysis of the possible behaviour that could amount to a misuse of information in this context is set out below. From our analysis, it appears that the first three limbs of the test are typically satisfied and that, in practice, much often turns on the last part of the test, “disclosure”.

### **Dealing and Arranging**

- 4.10 Under the Act behaviour includes any action or inaction and MAR 1.4.4E discusses behaviour in relation to the misuse of information consisting of dealing and arranging<sup>6</sup>. Consequently, all of the following behaviours fall within the definition of dealing or arranging:
- selling the underlying shares short;
  - entering into a derivative transaction to sell shares;
  - borrowing the underlying shares; and entering into some types of credit derivatives where the default provisions are linked to a qualifying investment;
  - contractual icing, whether undertaken on one’s own behalf or for a third party falls within the MAR 1 definition of dealing and arranging. Informal icing arranged by a third party, who will not ultimately become a principal to the stock loan, falls within the MAR 1 definition of arranging. But, where the parties entering into the informal icing arrangement in which they will themselves become parties to the stock loan, these arrangements are outside the definition of arranging in MAR 1.
- 4.11 However, even if certain types of icing do not fall within the criteria outlined in MAR 1.4.4E(1), icing will fall within Section 118(1)(a) of the Act<sup>7</sup>. For this reason we have considered the application of the regular user test in Section 118(1)(c) of the Act to all types of icing, whether or not they fall within the Glossary definitions of dealing or arranging and the circumstances identified in MAR 1.4.4E(1) (see 5.4 to 5.5 below).

### **Is the information generally available? MAR 1.4.4E(2) and MAR 1.4.5E**

- 4.12 The information that a forthcoming convertible/exchangeable bond is going to be launched is not generally available before launch. In practice, a launch occurs when the investment bank/lead manager either sends invitation telexes (which now includes e-mails and faxes etc) to its clients or markets the transaction whilst the listing particulars are being approved, or does both. Post launch, the

---

6 The terms *dealing* and *arranging* are defined in the Handbook Glossary as follows. *Dealing* is defined to accord with the meaning in paragraph 2 of Schedule 2 to the Act, and as such includes offering or agreeing to buy, sell, subscribe for or underwrite investments, either as principal or agent. *Arranging* is defined as the regulated activities specified in Articles 25(1), 25(2) and 64 of the Regulated Activities Order.

7 Section 122(2) of the Act outlines that the effect of MAR 1.4.4E is that it may be relied on so far as it indicates whether or not behaviour satisfying all the circumstances outlined therein should be taken to amount to market abuse. MAR 1.4.4E does not, therefore, operate to exclude behaviour falling outside the circumstances outlined in MAR 1.4.4E from amounting to market abuse as a misuse of information under the condition in Section 118(2)(a) (see also MAR 1.2.13G).

information that an issue has been launched rapidly becomes generally available to the market as those who receive the invitations share the information.

- 4.13 Some investment banks seek indicative prices from third parties in relation to the stock loan arrangements and credit derivatives prior to the launch, to enable them to price the convertible/exchangeable bonds. They may also sound out clients about potential demand for a type of issue. Some houses ask for confidentiality undertakings from these third parties and seek to restrict the use of the information because they consider the information to be price sensitive under the Criminal Justice Act 1993 (Insider Dealing). (It should be noted that if information is price sensitive, it will be considered as relevant information under the Code.) Others disagree with this analysis. It seems that information that a potential convertible/exchangeable bond is going to be issued may be leaked to the market. Sometimes, the rumours are very speculative, but on other occasions the information is surprisingly accurate. Whether a third party can act on the leaked information depends entirely on the provenance of the information and whether it can be said to be relevant information and generally available to the market illustrated by the factors required by MAR 1.4.9E and MAR 1.4.5E respectively.

**Is the information relevant? MAR 1.4.4E(3) and MAR 1.4.9E<sup>8</sup>**

- 4.14 The knowledge that there is going to be a forthcoming issuance of a convertible/exchangeable bond would be considered relevant information for all dealing and arranging. However, if a person is purely speculating that an issue is imminent, it would be acceptable to undertake dealing or arranging in the underlying shares, or in the securities of the issuer, provided the person is satisfied that he is basing his behaviour on information that could not be considered as relevant information.

**Is the relevant information “disclosable”? MAR 1.4.12E(1)**

- 4.15 It is very difficult to generalise about the relevant disclosure obligations. This is because of the different types of convertible/exchangeable bonds, and the differences in both listing rules and requirements concerning substantial shareholder’s disclosures across different jurisdictions. Some general principles are identifiable and the most common disclosure obligations under the UK listing rules are set out at Annex B.
- 4.16 Disclosure requirements may apply where a listed company issues a convertible/exchangeable bond or disposes of a cross shareholding. This is the case under the UK listing rules and/or the Companies Act 1985. In certain circumstances, the disclosure under the UK listing rules can be delayed while

---

<sup>8</sup> MAR 1.4.12E(1) “The information will fall within MAR 1.4.4E(4) if it is either: (1) information which has to be disclosed in accordance with any legal or regulatory requirement (referred to as “disclosable information”) or (2) information which is routinely the subject of a public announcement although not subject to any formal disclosure requirement (referred to as “announceable information”).

the marketing or underwriting is in progress. However, the disclosure is only delayed and the fact that a disclosure will need to be made in the future means that the embargo on dealing or arranging before the disclosure still applies. If the issuer of an exchangeable bond is not a listed company, but the underlying shares into which the exchangeable bond will convert trade on a prescribed market, then disclosure obligations under the Companies Act 1985 may be triggered. If the convertible/exchangeable bond itself is going to be listed, the issuer has to publish the listing particulars. However, the transaction can be marketed whilst the particulars are being approved, so the information that an issue is being launched may become generally available to the market before the admission to listing.

- 4.17 If a 'bought deal' is sold by a UK listed company, the transaction may attract a disclosure obligation in accordance with Listing Rules 9.10(a) or (j) (an issuer which only has specialist debt securities listed will attract disclosure obligations under Listing Rule 23-22). If the bought deal is packaged as a new issue, it may attract legal or regulatory disclosure obligations. Accordingly, the extent to which a disclosure obligation arises must be considered on a case-by-case basis.
- 4.18 If the convertible or exchangeable bond were to be listed, this would attract the same disclosure obligations on the publication of the listing particulars. However, the marketing of such a transaction is not prohibited whilst the listing particulars are being approved by the UK Listing Authority. So, sometimes the information that a convertible/exchangeable bond is being launched becomes generally available before the listing particulars are approved. In these circumstances, behaviour may occur at the point in time the information is generally available as opposed to having to wait for the approval of the listing particulars.

**Is the relevant information announceable? MAR 1.4.4E(4) and MAR 1.4.12E(2) <sup>9</sup>**

- 4.19 On the whole, we do not think that convertible/exchangeable bonds are announceable to the market in accordance with MAR 1.4.12E(2). They may be announced as part of the marketing process but this is different from announcements that are routinely and consistently made which are the tests laid down in MAR 1.4.12E(2).

Q4.1 Would you expect issues of convertible/exchangeable bonds which do not attract a legal or regulatory disclosure requirement to be routinely announced to the market?

---

<sup>9</sup> MAR 1.4.12E(2): Information will only fall within MAR 1.4.4E(4) if it is either: (1) information which has to be disclosed in accordance with any legal or regulatory requirement (referred to as "discloseable information"), or(2) information which is routinely the subject of a public announcement although not subject to any formal disclosure requirement (referred to as "announceable information")

**Is the information protected under the Trading Information safe harbour?  
Mar 1.4.26C**

- 4.20 Behaviour based on information can have the benefit of the safe harbour under MAR 1.4.26C if the information is based on someone's intention to deal or arrange, unless the information relates to new offers, issues, placements or other primary market activity (see MAR 1.4.26C(2)). So, this safe harbour is not available for pre-hedging convertible/exchangeable bonds structured as new offers, issues or placements, (which account for the majority of issues of these bonds).

Q4.2 Do you agree with the analysis regarding the availability of this safe harbour?

# 5 The standards expected by the reasonable regular user

- 5.1 The regular user test is a key element of the market abuse regime. Where the other conditions for constituting market abuse are met it is still necessary that the behaviour must fall below the standards expected by a regular user of the relevant market.
- 5.2 In our view, the regular user is likely to expect firms to:
- i) protect the confidentiality of information that a forthcoming convertible/exchangeable bond issue was going to be launched, before disclosure to the market; and

ii) ensure leaks do not occur across the different desks on the trading floor.

The convertible/exchangeable bonds are normally issued with the underlying shares amounting to approximately 5%-15% of the issued share capital of the relevant company. Once an issue is launched, in the short term, the underlying share price typically falls by as much as 3%-5% on average. Those people with information about the forthcoming issue could take advantage of this knowledge and trade ahead of the rest of the market. One could take a short position in anticipation of the fall in the share price and then cover the position at the lower price. This trading could have an impact on the market and may affect the pricing of the new issue. In our view, the regular user would be likely to regard this behaviour as unacceptable. The same would apply to entering into a derivative transaction to sell the underlying shares.

- 5.3 The regular user is likely to have the same view where a disclosure obligation exists and a firm pre-borrows shares before the market is aware of the new issue. In our view, the regular user is likely to consider this unacceptable as the availability of shares may be reduced making it difficult and/or very costly for other participants to cover their trading positions. It may also disadvantage lenders.

- 5.4 For icing shares, we consider that the regular user is likely to view ‘pay to hold’ arrangements, which involve binding legal obligations, as unacceptable, as they are akin to borrowing and likely to cause appreciable market disadvantage to others.
- 5.5 The current practice of informal icing as outlined in paragraph 3.11 of this paper is likely to be considered acceptable by the regular user before the launch of the convertible/exchangeable bond because the arrangements are non-contractual and the actual terms are agreed post launch. The terms include agreeing to the size of the stock loan, which lenders pro rate depending on demand. We appreciate that some lenders who allow icing of their shares may operate differently, but we take comfort from the best practice in the market and believe the regular user is likely to expect all lenders to follow this practice. This means that all market participants should be able to participate in the stock loan market, regardless of whether they need shares to hedge the convertible/exchangeable bond or as an outright position.
- 5.6 It is also our view that selling the underlying short, prior to the announcement of an issue, with a view to facilitating the purchase of the underlying after the announcement and thereby limiting the impact of the short selling by others at that time, is likely to be regarded by the regular user as a failure to observe the standard of behaviour reasonably expected of market participants. The regular user would expect market participants to comply with the requirements for stabilising activity that are contained in MAR 2 if they wish to rely on this safe harbour. These requirements include making a public announcement of the new issue prior to undertaking any stabilising action.
- 5.7 Underwriters may be concerned that they are disadvantaged if they are unable to pre-hedge a new issue before the launch, and therefore have position risk until the issue is sold. However, in our opinion, the regular user is likely to consider that they are paid to take this risk, that they may also be able to stabilise the issue, and should not be able to take advantage of their privileged position. Hence, dealing and arranging by them in advance of the disclosure of the launch of the bond would be likely to be considered by the regular user as unacceptable.
- 5.8 If underwriters are concerned that they are disadvantaged because they are unable to pre-hedge a new issue before the disclosure of the launch, it is in their interests to be extra diligent when sharing the information with third parties. If the process were managed appropriately with confidentiality undertakings and logging people over the Chinese wall, they could ensure that leaks would be kept to a minimum. In this way, other market participants would have less information and the market should be more efficient as leaks and rumours would be reduced.

Q5.1 Do you agree with this analysis of how the regular user is likely to view the behaviour outlined above?

- 5.9 Another important consideration for the regular user would be the disclosure obligations that apply to any transaction. We believe that the regular user would consider that where a regulatory obligation permitted the delay of the disclosure to the market, hedging the position before the disclosure would not be acceptable because MAR 1.4.13E would apply.

Q5.2 Do you agree that the regular user would be likely to consider that any permitted delay of the disclosure obligations under the listing rules applies only to the timing of the disclosure and does not permit dealing or arranging prior to the disclosure of the issue to the market?

- 5.10 It should also be remembered that where someone buys or borrows more shares than he requires to cover a position, with the intention of positioning the price of the underlying shares at a distorted level, this behaviour may in certain circumstances amount to distortion. This consideration applies whether or not the launch of the convertible/exchangeable bond attracts a disclosure requirement.

# 6 Conclusions

## Conclusions

6.1 It appears to us that:

a) the following activities will fall within the definition of dealing and arranging:

- selling the underlying equity short;
- entering into a derivative transaction to sell shares;
- borrowing the underlying shares;
- entering into some types of credit derivatives in relation to the convertible/exchangeable bond issue where the default provisions are linked to a qualifying investment;
- icing arrangements which are contractual in nature and binding on the parties, such as ‘pay to hold’ arrangements, and informal icing arrangements where the arranger will not be a party to the stock loan.

b) information about the forthcoming launch of a convertible/exchangeable bond typically will not be generally available before the launch of the issue is disclosed to the market;

c) such information will typically be relevant;

d) there are a number of circumstances where disclosure obligations arise regarding the launch of a convertible/exchangeable bond;

e) the “announceable information” test under the Code is not satisfied;

f) information regarding the launch of convertible/exchangeable bonds structured as new issues or placements does not fall within the Trading Information safe harbour as new issue activity is expressly excluded;

g) if the issuance of a convertible/exchangeable bond attracts a disclosure obligation, no dealing or arranging in the underlying shares except icing (in

the sense of an informal reservation of shares as opposed to contractual arrangements such as ‘pay to hold’ arrangements) would be acceptable before disclosure is made to the market. This applies regardless of whether a delay in making the disclosure is permitted;

- h) where there is a convertible/exchangeable bond and no disclosure obligation arises, there is no embargo on the use of the information under the Code;
- i) where icing involves no more than an informal reservation of shares on one’s own behalf, this does not amount to dealing and arranging and therefore does not meet the current tests for misuse of information under the Code. (We would expect that the regular user would be likely to consider informal icing arrangements acceptable.);
- j) the individual terms of any credit protection purchased in association with the issue of a convertible/exchangeable bond should be considered to establish whether they are linked to a qualifying investment, which would bring the credit derivative within the scope of the market abuse regime as a relevant product; and
- k) with a bought deal, if the seller is a UK listed company, it is under an obligation to disclose the transaction under listing rule 9.10 (a) or (j). As the winner of the bid would be aware that the company was obliged to make such a disclosure, MAR 1.4.13E would apply and so no pre-hedging activity would be allowed until such a disclosure was made. This information would not be protected by the trading information safe harbour (MAR 1.4.26C) as this activity falls within the exemption detailed in MAR 1.4.26C(2) as either a new issue, offer, placement or other primary market activity. Similarly, the unsuccessful bidders would also be prohibited from hedging as they would also have information that would be the subject of a future disclosure under MAR 1.4.13E, and the Trading Information safe harbour falls away for the reasons already explained.

# Guidance text

1. This *guidance* is relevant to *persons* who issue, manage, sell or purchase convertible/exchangeable bonds and details the *FSA's* views about the application of the *market abuse regime* to the current market practices employed when hedging such issues.
2. In brief, the *guidance* states that for convertible/exchangeable bonds whose launch is required to be disclosed to the market, no *dealing* or *arranging* in the underlying *shares* or related products is permissible prior to the disclosure to the market. However, informal arrangements to locate and have right of first refusal over shares from prospective lenders ('informal icing') will not amount to *market abuse* so long as those informal arrangements are commercially reasonable to facilitate the potential stock loan as a hedge and do not involve a contractual agreement.
3. Therefore dealing or arranging based on the possession of information that there is a forthcoming issue of a convertible/exchangeable bond, will, where that information is relevant, not generally available and has to be disclosed to the market, amount to *market abuse*. Selling the underlying *shares* short, prior to the announcement of an issue, with a view to facilitating the purchase of the underlying *shares* after the announcement and thereby limiting the impact of the short selling by others at that time, may also amount to *market abuse*.
4. There are many different types of convertible/exchangeable bonds; but for the purpose of this *guidance* we use the following definitions.
  - (i) **convertible bonds** are issued by a *company* for the purpose of raising capital and are convertible into the *company's* own *shares*. The company issues new *shares* in time for the conversion. Invariably the new *shares* will be fungible with the existing *shares* already traded on a *prescribed market*.
  - (ii) **exchangeable bonds** are issued by a *company* or *firm* and are convertible into a third party's *shares*; in this case, the issuer

normally has a long position in the underlying *shares* and is disposing of a substantial shareholding or cross shareholding.

5. For *behaviour* to amount to *market abuse*, the conditions set out in sections 118(1)(a)(b) and (c) of the *Act* must be satisfied (as described in MAR 1.1.3G). First, under section 118(1)(a), *behaviour* must occur in relation to a *qualifying investment* traded on a *prescribed market* (see MAR 1.11.2G for a list of these prescribed markets). As explained at MAR 1.11.6E section 118(6) provides non-exhaustive guidance on what will amount to *behaviour* in relation to a *qualifying investment*. In particular, *behaviour* can occur in relation to a *qualifying investment* traded on a *prescribed market* if the *behaviour* is in relation to other *investments* which are not themselves traded on a *prescribed market*. This is because such *behaviour* can have a damaging effect on *prescribed markets*. These products are referred to in the Code as *relevant products*. Examples of *relevant products* are provided in MAR 1.11.9E.
6. Consequently, for *behaviour* in relation to the issue of a convertible/exchangeable bond to come within the scope of *market abuse regime* it is necessary that
  - (i) the *issuer* of the bond is a *company* whose securities trade on a *prescribed market*; or
  - (ii) the underlying *shares* into which the bond can be converted are traded on a *prescribed market* and therefore the convertible/exchangeable bond is a *relevant product*; or
  - (iii) the convertible/exchangeable bond is traded on a *prescribed market*.
7. Second, under section 118(1)(b) of the *Act* one or more of the conditions in section 118(2) have to be met in order for *behaviour* to amount to *market abuse* (see MAR 1.1.3G). MAR 1.4.4E discusses the condition in section 118(2)(a) (referred to here as “misuse of information”). MAR 1.4.4E states that *behaviour* will amount to *market abuse* in that it will be a misuse of information where all the circumstances in MAR 1.4.4E(1) to MAR 1.4.4E(4) are present.
8. MAR 1.4.4E(1) only applies where a *person deals* or *arranges deals*. The following *behaviour* in relation to convertible/exchangeable bonds falls within the *Glossary* definition of *dealing* or *arranging*:
  - (i) selling the underlying *shares* short;
  - (ii) entering into a *derivative* transaction to sell the *shares*;
  - (iii) borrowing the underlying *shares*;

- (iv) entering into some types of credit derivatives in relation to the convertible/exchangeable bond where the default provisions reference a *qualifying investment*;
- (v) icing the underlying *shares* on a formal basis such that the arrangements are contractual in nature and thereby binding on the parties, such as ‘pay to hold’ arrangements. Icing means locating and reserving *shares* from prospective lenders. Informal non-contractual icing is a non-binding arrangement between the parties (see paragraph 9 below).
- (vi) informal non-contractual icing arrangements undertaken on behalf of a third party.

9. Where the icing of the underlying *shares* involves

- (i) the informal reservation of the *shares*;
- (ii) the terms not being offered or agreed until after the disclosure to the market; and
- (iii) the entity making the icing arrangements becoming a principal to the stock loan,

then the icing arrangements fall outside both the definitions of *dealing* and *arranging* that are used in MAR 1 (this is because the exclusion in Article 28 of the *Regulated Activities Order* will take the activity outside Article 25 of that Order and therefore outside the definition of *arranging* that is used in MAR 1). If the entity undertaking the icing arrangements is **not** one of the parties to the issue then the exclusion in Article 28 will not apply and the icing will amount to *arranging* even if the arrangements are non-contractual.

- 10. However, even if icing does not come within the circumstances outlined in MAR 1.4.4E(1) it will fall within section 118(1)(b) of the *Act* and the *market abuse regime*. MAR 1.4.4E does not operate to exclude *behaviour* falling outside the circumstances outlined in MAR 1.4.4E (see section 122(2) of the *Act* and MAR 1.2.13G). For this reason the guidance that is provided below on the application of the remaining elements in section 118(2)(b) and the regular user test in section 118(1)(c), will also apply to icing that is outside the Glossary definitions of *dealing* or *arranging* and the circumstances identified in MAR 1.4.4E(1) (see below).
- 11. This *guidance* concerns current market practice when hedging the issue of convertible/exchangeable bonds. By definition, such hedging (and its constituent activities) is *behaviour* “based on” the information that there is to be an issue of a convertible/exchangeable bond. This aspect of MAR 1.4.4E(1) is therefore satisfied.
- 12. MAR 1.4.4E(2) states that the information must not be generally available. The information that a forthcoming convertible/exchangeable bond is going to be

launched is not generally available before the launch (see MAR 1.4.5E which contains criteria for assessing whether information is generally available).

13. MAR 1.4.4 E(3) states that the information must be *relevant information*. The knowledge that there is going to be a forthcoming issuance of a convertible/exchangeable bond is *relevant information* for all *dealing* and *arranging* activity identified at paragraph 8 above (see MAR 1.4.9E to MAR 1.4.11E which contain criteria for assessing when information is relevant).
14. However, if a *person* is speculating that an issue is imminent, it would be acceptable to undertake *dealing* or *arranging* in the underlying *shares*, or in the securities of the issuer, provided the *person* is satisfied that he is basing his *behaviour* on information that could not be considered as *relevant information* or information which is not generally available.
15. MAR 1.4.4E(4) considers specific aspects of the regular user test in section 118(1)(c) of the *Act* in the context of the misuse of information. The last set of circumstances outlined in MAR 1.4.4E(4) are that the information must relate to matters which the regular user would reasonably expect to be disclosed to users of the particular *prescribed market*. If there is a legal or regulatory requirement to disclose the issue of the convertible/exchangeable bond to the market, the regular user would reasonably expect that no *dealing* or *arranging* should occur before this disclosure is made (see MAR 1.4.12E to MAR 1.4.15E). An exception to this may exist if the Trading Information safe harbour provided under MAR 1.4.26C applies (see paragraph 19 below).
16. Where there is no legal or regulatory requirement (such as that contained in the listing rules) to disclose the issue of a convertible/exchangeable bond, current market practice is that there is no routine announcement of the issue. Therefore, in the absence of a legal or regulatory requirement to disclose the issue, the *regular user* would not reasonably expect the information to be disclosed.
17. The third condition necessary for behaviour to amount to *market abuse* is that it is likely to be regarded by a *regular user* of that market as a failure to observe the standards reasonably expected of a person in his or their position in relation to the market. In relation to the issue of convertible/exchangeable bonds, the *regular user* is likely to expect a *person* to protect the confidentiality of information that a convertible/exchangeable bond issue is going to be launched when such a product attracts legal or regulatory disclosure obligations. The *regular user* is likely to consider that it is unacceptable for a *person* with information about a forthcoming convertible/exchangeable bond issue (that attracts legal or regulatory disclosure obligations and which does not receive the protection of the safe harbour in MAR 1.4.26C) to take advantage of this knowledge and *deal* or *arrange* in the underlying *shares* before the disclosure is made to the rest of

the market. *Dealing* or *arranging* currently includes all the activities identified at paragraph 8 above.

18. As discussed in paragraph 9 above, informal icing will sometimes fall outside the circumstances identified in MAR 1.4.4E but within the scope of the condition in section 118(2)(a) of the *Act*. However, informal icing described in paragraphs 8(vi) and 9 above, even when undertaken prior to the announcement of the issue is unlikely to be regarded by the *regular user* as falling below the standard expected of a *person* in the market. This is because the party undertaking the icing does not gain an advantage over other market practitioners. However in accordance with paragraph 17 above, the *regular user* is likely to expect a person to protect the confidentiality of the information that a convertible/exchangeable bond issue is going to be launched. A *person* making an icing request should also consider whether the request includes a selective and early disclosure of information that a *regular user* would expect to be disclosed to market participants and therefore whether a statement required by MAR 1.8.5G should be included in the request.
19. *Behaviour* based on information will receive the protection of the safe harbour under MAR 1.4.26C if the information is based on someone's intention to *deal* or *arrange*, unless the information relates to new offers, issues, placements or other primary market activity (see MAR 1.4.26C(2)). Consequently, if a convertible/exchangeable bond is structured as a new offer, issue or placement, then the safe harbour is not available.

### **Distortion**

20. Regardless of whether the launch of a convertible/exchangeable bond issue attracts a disclosure requirement, any icing which involves more *shares* than are required to cover a position may amount to distortion where the actuating purpose is to position the price of the underlying *shares* at a distorted level (see MAR 1.6.9E to MAR 1.6.12E).

### **The application of MAR 2**

21. Selling the underlying *shares* short, prior to the announcement of an issue, with a view to facilitating the purchase of the underlying *shares* after the announcement and thereby limiting the impact of the short selling by others at that time, is likely to be regarded by the *regular user* as a failure to observe the standard of *behaviour* reasonably expected of market participants. The *regular user* would expect market participants to comply with the requirements for *stabilising activity* that are contained in MAR 2 which include making a public announcement of the new issue prior to undertaking any *stabilising action*.

## Annex B

### Extracts from UK Listing Rules

#### Chapter 9 – Continuing Obligations

##### **General obligation of disclosure for companies**

9.1 A company must notify the Company Announcements Office without delay of any major new developments in its sphere of activity which are not public knowledge which may:

- (a) by virtue of the effect of those developments on its assets and liabilities or financial position or on the general course of its business, lead to substantial movement in the price of its listed securities; or
- (b) in the case of a company with debt securities listed, by virtue of the effect of those developments on its assets and liabilities or financial position or on the general course of its business, lead to substantial movement in the price of its listed securities, or significantly affect its ability to meet its commitments.

9.2 A company must notify the Regulatory Information Service without delay of all relevant information which is not public knowledge concerning a change:

- (a) in the company's financial condition;
- (b) in the performance of its business; or
- (c) in the company's expectation as to its performance;

which, if made public, would be likely to lead to substantial movement in the price of its listed securities.

9.4 A company need not notify to the Regulatory Information Service information about impending developments or matters in the course of negotiation, and may give such information in confidence to recipients within the categories described in paragraph 9.5. If the company has reason to believe that a breach of such confidence has occurred or is

likely to occur, and, in either case, the development or matter in question is such that knowledge of it would be likely to lead to substantial movement in the price of its listed securities, the company must without delay notify to the Regulatory Information Service at least a warning announcement to the effect that the company expects shortly to release information which may lead to such a movement.

9.5 The categories of recipient referred to in paragraph 9.4 are:

- (a) the company's advisers and advisers of any other persons involved or who may be involved in the development or matter in question;
- (b) persons with whom the company is negotiating, or intends to negotiate, any commercial, financial or investment transaction (including prospective underwriters or places of securities of the company);
- (c) representatives of its employees or trades unions acting on their behalf; and
- (d) any government department, the Bank of England, the Competition Commission or any other statutory or regulatory body or authority.

The company must be satisfied that such recipients of information are aware that they must not deal in the company's securities before the relevant information has been made available to the public.

9.6 Information that is required to be notified to the Regulatory Information Service must not be given to anyone else before it has been so notified, except as permitted by paragraphs 9.4 and 9.15.

9.7 Where it is proposed to announce at any meeting of holders of a company's listed securities information which might lead to substantial movement in their price, arrangements must be made for notification of that information to the Regulatory Information Service so that the announcement at the meeting is made no earlier than the time at which the information is published to the market.

### **Exception**

9.8 If a company considers that disclosure to the public of information required by paragraph 9.1 or 9.2 to be notified to the Regulatory Information Service might

prejudice the company's legitimate interests, the UK Listing Authority may grant a dispensation from the relevant requirement.

### **Notification relating to capital:**

9.10 A company must notify the Regulatory Information Service without delay (unless otherwise indicated) of the following information relating to its capital:

#### **Alterations to capital structure:**

- (a) any proposed change in its capital structure including the structure of its listed debt securities, save that an announcement of a new issue may be delayed while a marketing or underwriting is in progress (see also paragraph 9.38);

#### **Results of new issues**

- (j) the results of any new issue of listed securities other than specialist securities or of a public offering of existing securities. Where the securities are subject to an underwriting arrangement the issuer may at its discretion, delay notifying the Company Announcements Office until the obligation by the underwriter to take or procure others to take securities is finally determined or lapses (see also paragraph 9.42). In the case of an issue or offer of securities which is not underwritten, notification of the result must be made as soon as it is known.

### **Chapter 23 UK Listing Rules:**

#### **Continuing obligations**

23.22 Issuers other than states and their regional and local authorities which only have specialist debt securities listed need not comply with the continuing obligations set out in other chapters of the listing rules but are subject to the following continuing obligations:

#### **New developments**

- (a) the issuer must notify to the Regulatory Information Service any major new developments in its sphere of activity which are not public knowledge and which may:

(i) by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the price of the listed securities; or

(ii) significantly affect its ability to meet its commitments:

save that if the issuer considers that disclosure to the public of information required by this paragraph to be notified to the Regulatory Information Service might prejudice the issuer's legitimate interests, the UK Listing Authority may grant a dispensation from the requirement.

A company must take all reasonable care to ensure that any statement or forecast or any other information it notifies to the Regulatory Information Service or makes available through the UK Listing Authority is not misleading, false or deceptive and does not omit anything likely to affect the import of such statement, forecast or other information;

#### **New issues**

(e) any new issues of debt securities and any guarantee or security in respect thereof must be notified to the Regulatory Information Service without delay;

#### **Communications with holders**

(j) notify to the Regulatory Information Service all notices to holders of listed debt securities no later than the date of despatch. In addition, draft copies of any proposed amendment to the memorandum and articles of association which would affect the rights of such holders must be submitted to the UK Listing Authority;

# Summary of questions

Q3.1 Are you aware of any hedging practices other than the ones we have identified? If yes, what are they?

Q3.2 What are your views on the acceptability, or otherwise, of the behaviour outlined above (selling, borrowing and icing) before the launch of an issue is disclosed to the market?

Q3.3 Do you consider that a distinction can be drawn between informal icing arrangements and “pay to hold” agreements? In particular is it the case for informal icing arrangements that lenders are paid a premium when the shares are taken up or borrowed after the offer is announced, which essentially compensates the lender in a manner that is economically equivalent to a “pay to hold” agreement?

Q3.4 Are the standards regarding the behaviour of an underwriter different in this area? If so, why?

Q4.1 Would you expect issues of convertible/exchangeable bonds which do not attract a legal or regulatory disclosure requirement to be routinely announced to the market?

Q4.2 Do you agree with the analysis regarding the availability of this safe harbour?

Q5.1 Do you agree with this analysis of how the regular user is likely to view the behaviours outlined above?

Q5.2 Do you agree that the regular user would be likely to consider that any permitted delay of the disclosure obligations under the listing rules applies only to the timing of the disclosure and does not permit dealing or arranging prior to the disclosure of the issue to the market?

Q6.1 In what, if any, circumstances do you think that the making of an icing request will involve an early and selective disclosure of information that should be disclosed equally to all market participants? Do you think that paragraph 18 of the draft guidance text provides adequate guidance on this possibility?

# Cost benefit analysis

1. This cost benefit analysis seeks to present for comment our assessment of the incremental costs of adding this guidance to the annex of specialist topics in the Code, and our analysis of the benefits.
2. This draft guidance does not represent any significant change in policy. It does further clarify the application of the Market conduct sourcebook, namely the Code. This paper addresses an issue raised by the industry, namely whether it is acceptable for the lead manager/underwriter to enter into certain transactions to hedge a new issue in advance of the issue being disclosed to the market.
3. This paper considers the view of the regular user with respect to hedging an issue ahead of disclosure of the launch. The market abuse regime incorporates the regular user test which establishes that market abuse is ultimately determined by reference to whether “a regular user of that market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market”.
4. The challenge in giving guidance on the market abuse regime has always been to strike an appropriate balance between the benefits of clarity and the costs of inflexibility arising from too much prescription. For market participants, the clarity and efficiency given by this guidance reduces the compliance and legal costs of adhering to the Code and creates an equal opportunity to understand it. For the FSA, it reduces costs and increases efficiencies.
5. The FSA proposes to include this guidance in the annex of specialist topics to the Code. A full cost benefit analysis for the Code was included in CP59: Market abuse: A draft Code of Market Conduct.

## **Direct Costs**

6. The FSA would not expect that the proposed additional guidance would add significantly to the giving of guidance by us. In fact, the FSA anticipates that it will reduce the number of requests for guidance by firms and lessen the time spent by the FSA on giving guidance in this area. Therefore the FSA expects the incremental direct costs of the proposed additional guidance to be of minimal significance.

## **Compliance Costs**

7. The FSA intends the annex of specialist topics to clarify certain aspects of the Code. The FSA estimates that the costs of adjusting to the guidance is likely to

be of minimal significance. The FSA does not expect that this proposed additional guidance will result in any additional expenditure by firms. The guidance essentially serves to add clarity, rather than change policy.

8. The FSA needs to balance demands for clarity, certainty and enforceability on the one hand, with the need to provide a Code that is both usable and which does not inhibit innovation. The proposed addition of this specialist topic should not add unduly to the length and detail of the Code.
9. Market participants will spend time reading the proposed specialist topic on the pre-hedging of convertible/exchangeable bond issues in order to benefit from the guidance. However, the incremental cost of reading and digesting the proposed guidance should be of minimal significance.
10. This specialist topic has the status of guidance and is therefore non-binding.

#### **Indirect costs**

11. The FSA would not expect the proposed guidance to significantly alter hedging practices in the convertible/exchangeable bond market, nor would the FSA expect to see any significant impact on the number of new issues of such bonds. The FSA would also not expect that the proposed guidance would have a negative impact on competition in this market.
12. Some market participants, for example, underwriters, may be concerned that they will be disadvantaged if they are unable to pre-hedge a new issue before the disclosure of the launch of the issue and incur position risk until the issue is sold. However, underwriters' fees typically reflect the risk they assume in participating in the issue, and they may also minimise risk by stabilising the issue.

#### **Benefits**

13. The main benefit of adding this specialist topic is the further clarification of the market abuse sections of the Act, therefore providing greater certainty for market participants. The benefits of adding this specialist guidance should be that:
  - more guidance means greater certainty for both the regulator and the regulated, about which activities are subject to penalties under the Act;
  - the FSA will spend less time and effort responding to requests for guidance on the same issues; and
  - any incremental cost that market participants incur in trying to comply with the market abuse sections in the Act is likely to be more focused, which may improve the probability of successful compliance.

Q1: Do you agree that adding this specialist topic to the annex to the Market conduct sourcebook would impose costs of no more than minimal significance? If you disagree, please specify your concerns.

# Compatibility with the FSA's general duties

- 1 This statement explains why the FSA believes that the proposed annex of specialist guidance, when taken with the Code (MAR 1) is compatible with the FSA's general duties under section 2 of the Act. The main statement of compatibility for the Code is given in Annex D of CP59.

## **Compatibility with FSA's statutory objectives**

### the **market confidence objective**

- (a) The purpose of this specialist topic draft guidance is to offer additional clarity and certainty to the users of the convertible and exchangeable bond markets;

### the **public awareness objective**

- (b) This draft guidance will add to the public's awareness of standards of conduct expected of market participants and users in these markets;

### the **protection of consumers objective**

- (c) This draft guidance will add clarity and certainty on the standards expected by the regular user and will help deter market abuse and its negative effect on consumers particularly in the equity markets.

### the **financial crime objective**

- (d) This draft guidance will raise the awareness of market users and enable them to identify and report market abuse in this area.

## *Matters to which the FSA must have regard*

- 2 The FSA's reasons for believing that making the rules is compatible with its general duty to have regard to:
  - (a) **the need to use its resources in the most efficient and economic way** are that the proposed addition of this specialist topic draft guidance will reduce the need for the same individual guidance to be repeated for market participants by sharing the information with all market users;

- (b) **the responsibilities of those who manage the affairs of authorised persons** are to ensure compliance with the Code, and this draft guidance will help reduce the chance that firms may fall foul of the market abuse regime;
- (c) **the principle that a burden or restriction should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction** are given in the relevant section of the cost benefit analysis included in this paper;
- (d) **the desirability of facilitating innovation in connection with regulated activities** is that this specialist topic draft guidance would not restrict the ways in which a firm can carry on regulated activities as we would expect that additional certainty would lead to fewer impediments or delays, and guidance is not binding;
- (e) **the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom.** This draft guidance is not expected to impact the competitive position of the United Kingdom, but comments are invited on this conclusion;
- (f) **the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions.** The FSA does not believe that there are any adverse effects on competition arising from this draft guidance but rather that the additional clarity will enhance the level playing field for market participants. Consideration was given to this issue in the cost benefit analysis. Comments are invited on this conclusion;
- (g) **the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.** All firms who use UK markets are subject to the market abuse regime with the result that they will be on equal footing in terms of their ability to compete with each other.

*Acting in a way most appropriate to meeting FSA's statutory objectives*

- 3 The FSA believes it is discharging its general functions in these areas in the most appropriate way for the purpose of meeting its objectives, because this draft guidance will add to the understanding of market participants and give greater certainty to market users.
- 4 Apart from clarification of the guidance, no other approach was considered by the FSA to be a more appropriate way to enhance the understanding of market participants and give greater certainty to market users.

Q1 Do you agree with the assessment of the proposals' compatibility with our general duties as outlined above? Where you disagree, please explain why.

**ISBN: 0117048976**

The Financial Services Authority  
25 The North Colonnade Canary Wharf London E14 5HS  
Telephone: +44 (0)20 7676 1000 Fax: +44 (0)20 7676 1099  
Website: <http://www.fsa.gov.uk>

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.