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BRIEFING

# Pre-hedging convertible and exchangeable bond issues


**Executive summary**

The Financial Services Authority has published feedback on CP 149 and the text of the guidance added as an annex to the Code of Market Conduct. The guidance confirms that strategies entered into before the announcement of the launch of a convertible or exchangeable bond issue, for example short selling of the underlying shares by the manager or 'icing' or reserving shares to be borrowed later in order to facilitate short sales, are likely to be regarded as market abuse where there is a legal or regulatory requirement to disclose the issue of the convertible or exchangeable bonds.


Even before the entry into force of the market abuse regime in December 2001, its effect on the pre-hedging of convertible and exchangeable bond issues had been identified as an area of uncertainty and concern (see *Market Watch* issue no. 2, November 2001). After much informal consultation, the Financial Services Authority (FSA) published CP 149, *Pre-hedging convertible bond issues*, in July 2002. It has now published its feedback on CP 149 and the text of the guidance added as an annex to the Code of Market Conduct.

## The new guidance

The guidance covers strategies entered into before the launch of a convertible or exchangeable bond issue, for example short selling of the underlying shares by the manager of an issue or 'icing' or reserving shares to be borrowed later in order to facilitate short sales. As the launch has not yet been announced, behaviour based on knowledge of the forthcoming issue may amount to the misuse of information under the market abuse regime. However, it will only constitute market abuse if a regular user of the market would regard the behaviour as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position. The FSA's Code of Market Conduct and the annex to it published in the feedback statement indicate how the FSA thinks a regular user would regard pre-hedging.

The Code of Market Conduct takes the position that behaviour based on information will only amount to market abuse where the information relates to matters that the regular user would reasonably expect to be disclosed to users of the market in question. The FSA confirms in the guidance that this condition will be satisfied where there is a legal or regulatory requirement to disclose the issue of the convertible or exchangeable bonds (as there typically would be if the issue was listed). However, where there is no such requirement, the FSA notes that market practice is for there to be no routine announcement of the issue and it concludes that the regular user would therefore not expect the proposed issue to be disclosed. Pre-hedging an issue that there was no legal or regulatory requirement to disclose would not, therefore, amount to market abuse.

Where the launch of the bond issue is required to be disclosed to the market, the FSA takes the view, as indicated in CP 149, that dealing or arranging deals in the underlying shares or related products before disclosure to the market is likely to amount to market abuse. Dealing for these purposes would include selling the underlying shares short, borrowing the shares in order to settle short sales or entering into derivative transactions in relation to the shares. Arranging deals would include entering into icing arrangements. In CP 149, the FSA had suggested that the regular user would regard informal icing arrangements that did not amount to a legal commitment (and that would not constitute 'arranging') as acceptable. Having talked further with market participants, the FSA no longer regards this as a consensus view, and it has concluded that even informal icing arrangements are likely to amount to market abuse in

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these circumstances (although enquiries of potential lenders in order to locate stock will be acceptable).

The FSA identifies only two exceptions to the general prohibition on pre-hedging. The first is arranging to borrow shares from the issuer or a related party. This is likely to be acceptable where the issuer or related party holds shares that are not a part of the usual lending market, provided that there is a genuine need to pre-arrange the borrowing in order to facilitate the bond issue.

The second exception relates to exchangeable bond issues. Many had argued that exchangeable bond issues had more in common with secondary market trades than with primary market activity: they essentially represent a means of disposing of a holder's interest in shares that have already been issued. The Code of Market Conduct contains a safe harbour for dealing or arranging deals based on information on secondary market trades but this safe harbour is unavailable for exchangeable issues because they involve a new issue of securities. Responding to these concerns, the FSA has amended its proposals in CP 149 in relation to exchangeables. It now takes the view that, where an exchangeable issue is a 'privately negotiated or structured transaction', a regular user of the market is likely to view pre-hedging by the parties to the transaction as acceptable behaviour. However, the usual rule will apply to exchangeable issues 'that are the subject of a public marketing effort'.

## Issues raised

It will obviously be difficult to know exactly where to draw the line between the two types of exchangeable issue. The FSA suggests that factors to be taken into account are how widely distributed the issue is and whether such transactions are routinely announced prior to completion (as opposed to any ex-post disclosure required by the listing rules).

Pre-hedging an exchangeable issue could also involve insider dealing concerns. However, knowledge of a forthcoming issue could be regarded as 'market information', and it is permissible under the insider dealing legislation to deal as an insider on the basis of market information if it is 'reasonable' to do so. The fact that the FSA has taken the view, after extensive consultation, that a regular user would regard pre-hedging a 'private' issue as acceptable is likely to be helpful in concluding that it should be regarded as reasonable for the purposes of the market information defence.

Looking beyond the scope of the guidance itself, market participants may ask whether the principles behind it could apply to other types of behaviour or instruments. For example, would a regular market user regard it as legitimate to deal in the underlying securities in the knowledge that a 'private' repackaging of those securities, or warrant issue relating to those securities, was about to be launched?

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