

**MARKET CONDUCT SOURCEBOOK
(PRE-HEDGING CONVERTIBLE
AND EXCHANGEABLE BOND ISSUES)
INSTRUMENT 2003**

Powers Exercised

- A. The Financial Services Authority makes this instrument in the exercise of the power in section 157(1) of the Financial Services and Markets Act 2000 (Guidance).

Commencement

- B. This instrument comes into force on 1 June 2003.

Amendments to the Market conduct sourcebook

- C. MAR 1 (The Code of Market Conduct) is amended in accordance with the Annex to this instrument.

Citation

- D. This instrument may be cited as the Market Conduct Sourcebook (Pre-hedging Convertible and Exchangeable Bond Issues) Instrument 2003.

By order of the Board
17 April 2003

Annex

Amendments to the Market conduct sourcebook

The Code of Market Conduct

Annex 3G: Insert after Table 2 the following new table:

3 Table

Pre-hedging convertible and exchangeable bond issues

Application

1. This *guidance* is relevant to *persons* who manage convertible and exchangeable bond issues and *persons* who issue, sell or purchase convertible and exchangeable bonds. The *guidance* details the *FSA's* views about the application of the *market abuse regime* to the current market practices employed when pre-hedging such issues.

Summary

2. In brief, this *guidance* states that for convertible and exchangeable bonds whose launch is required to be disclosed to the market, *dealing* or *arranging* in the underlying *shares* or related products, before disclosure to the market and while in possession of information about the launch, is likely to amount to *market abuse*. For example, it is likely to be *market abuse* for a *person*, who possesses information about a disclosable convertible or exchangeable bond launch, to sell the underlying *shares* short before the announcement of the launch, with a view to facilitating the purchase of the underlying *shares* after the announcement.
3. However, there are circumstances where the *FSA* believes the *regular user* is likely to view certain pre-hedging activity as acceptable, and these are noted in paragraphs 18 to 21 (Pre-arranging to borrow shares from the issuer) and 23 to 26 (Exchangeable bond issues) of this annex.

Meaning of “convertible and exchangeable bonds”

4. There are many different types of convertible and exchangeable bonds; but this *guidance* uses the following definitions:

(1) convertible bonds are bonds 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 existing *shares*;

(2) exchangeable bonds are bonds issued by a *company* and are convertible into a third party’s *shares*; in this case, the issuer normally has an existing holding in the underlying *shares* and is disposing of a substantial shareholding.

Detailed guidance

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).

Behaviour in relation to a qualifying investment

6. 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 in *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* where the *behaviour* is not in a *qualifying investment*. This is because such *behaviour* can nevertheless have a damaging effect on *prescribed markets*. This includes *behaviour* in *relevant products* as discussed in *MAR* 1.11.9E.

7. Consequently, for *behaviour* in relation to the issue of a convertible or exchangeable bond to come within the scope of the *market abuse regime*, it is necessary that:

(1) the underlying *shares* into which the bond can be converted are traded on a *prescribed market* and therefore the convertible or exchangeable bond is a *relevant product*; or

(2) the convertible or exchangeable bond is traded on a *prescribed market*.

Behaviour which amounts to misuse of information

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) (referred to here as “misuse of information”). *MAR* 1.4.4.E 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.
9. *MAR* 1.4.4E(1) applies only where a *person deals* or *arranges deals*. In using these defined terms, *MAR* 1.4.4E(1) has a broad compass, since the *Glossary* definitions of *dealing* and *arranging* both have an extended meaning. *Dealing*, for instance, relates to the activity of dealing as described in paragraph 2 of Schedule 2 to the *Act*, and thus does not include the various exceptions that would have applied had the term been defined by reference to the *Regulated Activities Order*. Further, *arranging* covers not only *arranging (bringing about) deals in investments* within article 25(1) of the *Regulated Activities Order* and *making arrangements with a view to transactions in investments* within article 25(2) of the *Regulated Activities Order*, but *agreeing to carry on either of those activities* within article 64 of the *Regulated Activities Order*. Accordingly, the following *behaviour*, in particular in relation to convertible or exchangeable bonds, falls within one or other of the *Glossary* definitions of *dealing* and *arranging*:

(1) selling the underlying *shares* short;

(2) entering into a *derivative* transaction to sell the *shares*;

(3) borrowing the underlying *shares*;

- (4) entering into some types of credit *derivatives* in relation to the convertible or exchangeable bond.
10. The following *behaviour* in relation to convertible or exchangeable bonds will also fall within one or other of the *Glossary* definitions of *dealing* or *arranging*:
- (1) icing (that is, locating and reserving *shares* from prospective lenders) the underlying *shares* on a formal basis such that the arrangements are contractual in nature and so binding on the parties, such as ‘pay to hold’ arrangements; since the borrowing of stock involves a transaction of sale and purchase, this applies whether the formal, contractual, icing is with a view to subsequent borrowing by the *person* icing the *shares* or is for borrowing by a third party;
- (2) informal, non-contractual, icing arrangements, for example, where the icing of the underlying *shares* involves the informal reservation of the *shares*, the terms not being offered or agreed until after the disclosure to the market; in this case, however, the definitions cover the case only where the icing is undertaken on behalf of a third party.
11. Where icing arrangements are informal and non-contractual in nature, and are with a view to subsequent borrowing for the *person* icing the *shares*, they will fall outside both the definition of *dealing* and that of *arranging*. This would be because the fact that the entity making the icing arrangements is to become a principal to the stock loan means that there would be no agreement to borrow (in other words *deal*) within paragraph 2 of Schedule 2 to the *Act* and, in relation to *arranging*, the exclusion in article 28 of the *Regulated Activities Order* would apply. However, even if such icing does not come within the circumstances outlined in *MAR* 1.4.4E(1), it will still fall within section 118(1)(b) of the *Act* and the *market abuse regime*. *MAR* 1.4.4E does not operate to exclude from the *market abuse regime* all *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 in this annex 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* and *arranging* and thus not covered by *MAR* 1.4.4E(1).

12. This *guidance* concerns current market practice when pre-hedging the issue of convertible and exchangeable bonds. By definition, such pre-hedging (and its constituent activities) is *behaviour* “based on” the information that there is to be an issue of a convertible or exchangeable bond. Therefore, this aspect of *MAR 1.4.4E(1)* is satisfied.
13. *MAR 1.4.4E(2)* states that the information must not be generally available. The information that a forthcoming convertible or 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).
14. *MAR 1.4.4E(3)* states that the information must be *relevant information*. The knowledge that there is going to be a forthcoming issue of a convertible or exchangeable bond is *relevant information* for all *dealing* and *arranging* activity identified at paragraph 9 (see *MAR 1.4.9E* to *MAR 1.4.11E* which contain criteria for assessing when information is relevant).
15. However, if a *person* is speculating that an issue is imminent or trading on the basis of rumour, 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 is generally available, or that the information is not relevant.

Application of the regular user test

16. *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. *MAR 1.4.4E(4)* requires the information to 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 or 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 by *MAR 1.4.26C* applies, or in

the circumstances outlined in paragraphs 18 to 21 (Pre-arranging to borrow *shares* from the issuer) or 23 to 26 (Exchangeable bond issues).

17. Where there is no legal or regulatory requirement (such as that contained in the listing rules) to disclose the issue, 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.

Pre-arranging to borrow shares from the issuer

18. The *regular user* may consider that it is acceptable *behaviour* for the manager of a convertible or exchangeable bond issue to arrange to borrow *shares* from the issuer or a related party of the issuer before the announcement of the launch of the issue. The *shares* held by the issuer or a related party are often not part of the lending market, and the issue manager may need to have access to the issuer's or a related party's pool of available *shares* in order to facilitate the transaction; for example, by meeting post-announcement hedging demand. Although there may be stock available in the market from other lenders, the need to pre-arrange to borrow the issuer's or a related party's *shares* may be critical to the success of the issue.
19. In determining that such *behaviour* is acceptable, the regular user is likely to view borrowing *shares* from the issuer or a related party as an acceptable practice in circumstances where:
 - (1) there is a genuine need to prearrange to borrow the *shares* to facilitate the issue;
 - (2) the parties to the pre-arranged borrowing are all aware of the forthcoming bond issue; and
 - (3) other market participants are not disadvantaged (see paragraphs 20 and 21).
20. There will be circumstances when the *regular user* is likely to regard borrowing from the issuer or a related party as unacceptable. An example would be if issuers or related

parties withdraw stock from the lending market in order to lend it to the issue manager in such a way that other market participants are disadvantaged.

21. For the issuer or a related party, when considering whether it is acceptable to make stock available to the issue manager, account needs to be taken not only of the extent to which stock will or may be lent to the issue manager, but also of the extent to which the stock has been available to the lending market. Factors which will be relevant in making this assessment are how recently and in what volume the stock to be lent to the issue manager has been available to the market. If the stock has been available to the lending market in some volume, and the amount that is to be lent to the issue manager will substantially reduce that volume, issuers or related parties need to be aware that withdrawing the stock may mean that they are engaging in *market abuse* by creating an abusive squeeze (*MAR* 1.6.13E).

Trading information safe harbour

22. Under *MAR* 1.4.26C, *behaviour* will not amount to a misuse of information if it is based on information about a *person's* intention to *deal or arrange deals*. However, the protection of this safe harbour does not apply if the *dealing* or *arranging* is based on information relating to new offers, issues, placements or other primary market activity (see *MAR* 1.4.26C(2)). Convertible bond issues are likely to be primary market activity, as they invariably involve the issue of new *securities*, in the form of the bond, and may also involve the contemporaneous issue of new *shares*; if so, therefore, the protection of the safe harbour will not be available to these products.

Exchangeable bond issues

23. Similarly, an exchangeable bond issue which has been the subject of an extensive marketing effort is likely to be part of the primary market, because it is itself a *security*, and therefore will also fall outside the protection of the safe harbour. It may be suggested that an exchangeable bond issue which is privately negotiated or structured has many of the characteristics of secondary market trades, and should therefore benefit from the trading information safe harbour in *MAR* 1.4.26C. However, since, as explained in

paragraph 22, the exchangeable bond involves the listing of new *securities*, even such an issue is likely to be considered as primary market activity.

24. Nonetheless, in determining whether there is an exposure to the *market abuse* regime taken as a whole, a distinction can be drawn between convertible or exchangeable bond issues that are the subject of a public marketing effort and consequently have an impact on a substantial number of market participants, and those exchangeable issues that are privately negotiated or structured transactions.
25. Factors which should be taken into account when drawing the distinction in paragraph 24 are:
 - (1) how widely distributed the issue is; and
 - (2) whether such transactions are routinely announced prior to completion (as opposed to purely ex-post disclosures, for example, under the listing rules).
26. Although the privately negotiated or structured transactions referred to in paragraphs 24 and 25 may not benefit from the trading information safe harbour, it is likely that the *regular user* would view pre-hedging of these issues by parties to the transaction as acceptable behaviour. Accordingly behaviour amounting to *dealing* or *arranging* as stated in paragraph 9 of this annex in connection with such exchangeable bond issues will not amount to *market abuse* because the *regular user* test in section 118 (1) (c) of the *Act* is not satisfied.

The application of *MAR 2* (Price stabilising rules)

27. The *regular user* would expect relevant market participants to comply with the requirements for stabilising activity as set out in *MAR2* where these are applicable; they include the making of a public announcement of a new issue before undertaking any stabilising action.

