

FCA takes first enforcement action for breaches of Short Selling Regulation

In October 2020 the FCA issued a Final Notice to Asia Research and Capital Management Ltd (**ARCM**). The FCA found that between 22 February 2017 and 3 December 2019, ARCM failed to make a number of notifications to the FCA and disclosures to the public that it was required to make under the Short Selling Regulation (236/2012) (**SSR**) in relation to a net short position in a particular issuer's shares.

As a result, the FCA took enforcement action against ARCM for breaching Articles 5 and 6 of the SSR. It imposed a financial penalty of £873,118 on ARCM.

This is the first time the FCA has taken enforcement action against a market participant for breaching the SSR. The case also involves several other interesting practice points.

Background and facts

The SSR requires market participants to provide the relevant competent authority and the public with details of net short positions held in certain financial instruments. The FCA is the competent authority under the SSR for financial instruments that are admitted to trading on any trading venue in the UK.

For the purposes of the SSR, a net short position in relation to shares of an issuer is the position which results from the difference between any short position and any long position held by a market participant in relation to the issued share capital of an issuer.

If a market participant holds a net short position that exceeds certain thresholds, it must notify the short position to the FCA and, in some cases, to the public via the FCA's website. These thresholds are calculated by reference to the proportion of an issuer's issued share capital that they represent.

Market participants must calculate whether it has passed the applicable notification thresholds by calculating the size of the net short position as at midnight on the day on which it holds the position. Any notifications that are required must be made to the FCA by 15.30 on the following trading day.

Facts

ARCM is an asset management firm based on Hong Kong. It is not (and has never been) authorised by the FCA.

Between 22 February 2017 and 3 December 2019, ARCM failed to make a number of notifications to the FCA (155) and disclosures to the public via the FCA's website (153) that it was required to make under the SSR in relation to a net short position in a

particular issuer's shares (Net Short Position). ARCM had accumulated the Net Short Position through equity swap transactions.

The size of ARCM's net short position in this issuer's shares was significant and, at one point was equivalent to 16.85% of the relevant issuer's issued share capital. The FCA described it as "*the largest net short position held in an issuer admitted*

to the [FCA's] Official List with shares admitted to trading on the Main Market of the London Stock Exchange".

Enforcement action

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financial penalty of £873,118 on ARCM.

Decision insight

This is the first time the FCA has taken enforcement action against a market participant for breaching the SSR. However, this case also involves several other

interesting practice points, which are considered in the sections below.

Length of time taken to notify FCA about SSR breaches

ARCM identified and proactively notified the FCA about its breaches of the SSR. However, it took ARCM 32 days to do so from the point at which ARCM identified that it may have failed to make the requisite notifications to the FCA under the SSR in relation to the Net Short Position.

In particular:

- On 29 October 2019, ARCM became aware that the SSR required market participants to report short selling activity through equity swaps in the UK to the FCA. At this point, ARCM started to consider whether the Net Short Position might be subject to this requirement.
- Between 29 October 2019 and 7 November 2019, ARCM took steps to confirm whether the obligations in the SSR applied to the Net Short Position. It also took steps to ascertain the precise disclosure obligations that market participants are required to adhere to under the SSR, as well as the relevant notification procedures that market participants are required to follow.
- On 8 November 2019, ARCM determined that it should have made the notifications referred to above to the FCA in relation to the Net Short Position.
- ARCM then began preparing the data and notifications that it should have submitted to the FCA in accordance with the SSR. This process

appears to have taken ARCM some time for a variety of reasons. For example, ARCM implemented a process to ensure that the notifications that it was preparing for the FCA were comprehensive and accurate, which required ARCM to review the full history of the Net Short Position. ARCM instructed external consultants to assist it with this process. In addition, this period coincided with the social unrest caused by protests in Hong Kong, which caused delays to the work of ARCM and its external consultants.

- On 29 November 2019, ARCM notified the FCA that it had failed to make a significant number of notifications in relation to the Net Short Position and that it would be submitting these notifications to the FCA as soon as it was able to.
- ARCM submitted 155 SSR notifications in relation to the Net Short Position to the FCA on the evening of 3 December 2019. Almost all of these notifications (153) were disclosed to the public via the FCA's website on 4 December 2019.

The FCA made it clear in its final notice that it considered that ARCM took too long to notify the FCA that it had failed to make a significant number of the notifications that it was required to make under the SSR in relation to the Net Short Position. In particular, the FCA noted that:

“ARCM did not inform the Authority promptly upon discovering its failure to comply with the relevant obligations under the SSR, and instead notified the Authority only after it had reviewed and collated the relevant data for disclosure.”

The FCA did not state when it thought ARCM should have notified the FCA of this matter. However, it can be inferred from the statement above that the FCA would have at least expected ARCM to notify it on or at least shortly after 8 November 2019, which was when ARCM confirmed that it had failed to make the relevant notifications to the FCA in respect of the Net Short Position in breach of the SSR. In practice, ARCM did not notify the FCA of this matter for a further 21 days.

Extra-territorial application of SSR

ARCM is based in Hong Kong and was described by the FCA as having *“very infrequently taken short positions in companies in EU markets”*.

The FCA acknowledged that ARCM had taken steps in order to ascertain what, if any, regulatory reporting obligations that it may have in the UK. For example, the FCA described how ARCM had *“relied on third party materials”* about UK regulatory reporting obligations that contained information relating to the SSR.

However, these materials *“included an indicative, rather than an exhaustive, list of the instruments to which the SSR applied”*. In particular, these materials did not expressly state that derivatives

Financial penalty calculation

This is the first time the FCA has been required to calculate a financial penalty for a firm that has breached the SSR.

Starting point

The FCA did not use ARCM's relevant revenue as its starting point for calculating ARCM's financial penalty. Instead, the FCA selected an alternative figure, namely the cumulative value of the percentage of issued share capital that was equal to

ARCM is not authorised by the FCA and, as a result, is not subject to Principle 11 of the FCA's Principles for Businesses, which requires firms to *“deal with its regulators in an open and cooperative way, and [...] disclose to the FCA appropriately anything relating to the firm of which that regulator would reasonably expect notice”*. However, the FCA's comments in this case should serve as a reminder for all firms that the FCA does not expect there to be a significant delay between breaches of its requirements being identified by firms and those breaches being notified to the FCA, even if that time is spent trying to find out more about and/or rectify the issues identified.

trading fell within the scope of the SSR. As a result, ARCM failed to identify that the SSR applied to the equity swap transactions that had given rise to the Net Short Position and failed to make the necessary notifications to the FCA when it was required to do so.

It is not clear how ARCM identified that it might be required to make notifications to the FCA under the SSR in relation to the Net Short Position. However, the facts of this case serve as a reminder that firms that are located outside the UK but undertake trading on UK markets must take adequate steps to familiarise themselves with the specific UK requirements that may apply to such trading.

the Net Short Position as its starting point. The FCA considered that this figure was a more appropriate indicator of the harm or potential harm that ARCM's breaches caused.

In most cases involving firms, the FCA uses between 0% to 20% of a firm's relevant revenue or an alternative figure that it selects in order to calculate a financial penalty. However, in this case the FCA selected 0.5% of the cumulative value of the percentage of issued share capital that was equal to the Net Short Position as its starting point. The FCA confirmed it would select between 0% and 1% of equivalent figures in future cases involving breaches of the SSR in order to calculate financial penalties.

It is not unheard of for the FCA to adopt an alternative approach to calculating financial penalties for certain specific types of cases. For example, the FCA takes alternative approaches to calculating financial penalties for listed issuers for breaches of their market announcement obligations and for regulated firms that are found to have breached the FCA's transaction reporting rules.

Proportionality reduction

The FCA may decrease the level of financial penalty arrived at after the steps that it has taken above if it "*considers that the penalty is disproportionately high for the breach concerned*" (DEPP 6.5.3(3)G). The FCA has used this mechanism in six cases in the last three years. Reductions applied to financial penalties in these cases ranged between 50% and 95%.

The FCA opted to reduce ARCM's financial penalty on grounds of proportionality, although ARCM's financial penalty was reduced by a more modest 25%.

The FCA does not usually explain why it has decided to use this mechanism in specific cases, other than to say that it has taken this step in order to ensure that the relevant financial penalty is not disproportionately high for the breaches concerned. However, in this case the FCA explained that it reduced ARCM's financial penalty on grounds of proportionality because ARCM's "*breaches stemmed from the same root cause failure in ARCM's compliance environment*" (that is, ARCM's failure to identify that it was required to make notifications relating to the Net Short Position to the FCA under the SSR).

Aggravating and mitigating factors

The FCA did not increase or decrease the financial penalty imposed on ARCM based on any of the aggravating or mitigating factors that it identified in relation to ARCM's conduct.

One of the mitigating factors the FCA identified in relation to ARCM's conduct was that ARCM self-identified its failure to comply with the SSR. However, it is likely that any credit that ARCM may have received for doing so was negated by the length of time that it took ARCM to notify the FCA of its failure to comply with the SSR.

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