

Statement on short selling United Kingdom Financial Services Authority (FSA)

Introduction

This statement outlines the measures already taken by the UK on short selling and the proposals under consideration for a permanent regime both in the UK and the European Union. It also sets out the FSA's current thinking on the following issues:

- (a) Whether there are any circumstances in which short selling should be banned;
- (b) Other forms of direct constraint such as price test rules or circuit breakers;
- (c) Whether we should have aggregated or individual position disclosure;
- (d) Whether disclosure should be to the market or to the regulator;
- (e) Disclosure thresholds;

While there are some differences of approach between the UK and US on short selling regulation it is worth emphasising that our overall objectives are similar. Our view is that both countries consider that short selling is a legitimate technique which assists market efficiency and liquidity as well as risk management. However, both also believe there is a need to have mechanisms that mitigate the potential for market abuse or the disorderly markets that it can give rise to.

Current measures in the UK

Until last year the UK had no specific measures concerning short selling. However, in June 2008 in light of concern about the possibility for abuse in rights issue stocks arising from the fragile market conditions, a requirement was introduced for a one-off disclosure of net short positions of 0.25% and above in the shares of companies undertaking rights issues. No time limit was set for this requirement and it remains in force.

In September 2008, at the height of the financial crisis, when we were particularly concerned about the risks to orderly markets posed by short selling, we introduced a temporary ban on the creation or increase of net short positions in UK financial sector stocks. We also introduced a requirement to make public disclosure of pre-existing individual net short positions of 0.25% and above in such stocks. There is also an ongoing requirement to disclose publicly any change (up or down) of net short position of 0.1% or above.

In January 2009, the ban lapsed, but the disclosure regime continued. We did, however, confirm our readiness to reintroduce the ban without consultation if warranted. Market conditions have eased since then and, to date, we have seen no case to reintroduce the ban. In June 2009 the UK financial stock disclosure requirement was extended indefinitely. However, it is not intended to be permanent and will be replaced when agreement has been reached on a comprehensive regime.

Future plans in the UK

When we introduced short selling measures in September 2008, we committed to conduct a general review of short selling. Our Discussion Paper, DP 09/1 http://www.fsa.gov.uk/Pages/Library/Policy/DP/2009/09_01.shtml (DP), published in February 2009, was the outcome of that review. Our key proposals were that there should be:

1. no form of permanent ban or direct constraint (e.g. price test rules) on short selling;
2. the ability to introduce a ban on an emergency basis;
3. public disclosure of individual positions for all UK stocks $\geq 0.5\%$;
4. public disclosure of short positions $\geq 0.25\%$ in rights issue stocks; and

5. on-going obligations to disclose changes of position $\geq 0.1\%$.
(all of these disclosures to be made at T +1)

However, we were clear that we were looking to achieve as wide an international consensus as possible and therefore would be prepared to consider modifications if this was necessary to reach a harmonised position on a short selling regime. We will publish our Feedback Statement on 1 October 2009 but, given our stance on finding international agreement, will not formally table any rules changes at this stage.

The European picture

The majority of European securities regulators introduced new measures to regulate short selling in the period following the FSA's intervention last September. These included bans on naked/covered short selling of stocks and disclosure requirements of various sorts. As a result, the Committee of European Securities Regulators (CESR) established a short selling task force, chaired by the FSA, to examine the scope for a permanent harmonised regime. The work of the Task Force led to CESR publishing a Consultation Paper on short selling disclosure¹ in July 2009. The proposals were similar to the FSA's but, in addition to public disclosure of individual net short positions at 0.5%, also proposed that there should be confidential disclosures to the regulator at 0.1%. The CESR proposals also apply to a geographically wider population of stocks. The CESR consultation closes on 30 September. We anticipate that this process will result in a proposal for a new EU Directive being published sometime in the course of 2010. CESR has prioritised developing proposals on disclosure, but a number of other options for the regulation of short selling (e.g. enhanced settlement discipline, constraints on naked short selling) continue to be discussed.

The key issues

(a) Bans

We have considered the impact of a permanent ban on short selling, either on a blanket or a targeted (i.e. sectoral) basis and believe it is likely that taking such action would deprive the market of the beneficial effects of short selling. We are also yet to be persuaded of a causal link between naked short selling and settlement failure in the UK. In so far as there is any such risk, it could be adequately addressed through the robust settlement and buy-in structures already in place in the UK. In addition, a ban on naked short selling could adversely impact liquidity and raise transaction costs by increasing demand in the stock lending market. However, we think we should still be able to introduce an emergency ban on short selling (both covered and naked), particularly where it poses an unacceptable risk of disorderly markets.

(b) Other direct constraints on short selling: price-test rules, circuit breakers

We recognise that other regulators continue to actively consider proposals for short sale price tests and circuit breaker restrictions. There are a number of circuit breaking arrangements in place in the UK already – for example, the London Stock Exchange's Automated Execution Suspensions and Price Monitoring Executions. However, the view in the UK is that further restrictions would not necessarily be effective and the cost of implementation would be high. Nevertheless, we will continue to monitor closely developments in other jurisdictions on this topic.

(c) Aggregated disclosure versus individual position disclosure

¹ CESR/09-581, 'CESR Proposal for a Pan-European Short Selling Disclosure Regime' – http://www.cesr-eu.org/index.php?page=consultation_details&id=142

The absence of appropriate infrastructure means that an aggregate short interest disclosure regime based on short sale marking would be very expensive to implement in the UK. The variant of having significant positions disclosed to the regulator, who would then aggregate and publish them on an anonymised basis, would be costly and would not, in any event, provide a complete informational picture. In addition, a regime based solely on aggregation and anonymised disclosure would not have the same deterrent benefits as disclosure of significant individual positions.

(d) Disclosure to the market versus disclosure to the regulator

Public disclosure of individual positions seems to provide the best compromise between seeking to retain the benefits of short selling while mitigating its negative aspects. Public disclosure serves two important functions: it provides greater transparency to the market; *and* it provides some measure of deterrence to those short selling strategies that are either, of themselves, abusive, or that might pose an unacceptably high risk of creating disorderly markets.

We recognise that public individual position disclosure is not welcome in all quarters. The principal objections to it are: concerns about the risk of “herding” behaviour when the identities of big-name short sellers are revealed; the risk of short “squeezes” by competitors; disclosure of intellectual property; and, as a result, anticipated reduced levels of short selling and resultant poorer market quality.

While public individual position disclosure may have some effect on levels of short selling, we do not expect it would do so to any degree that will materially reduce market quality. Our analysis has not produced any evidence that these concerns have materialised in the UK markets to date. It appears to show that overall levels of short selling are in line with what would be expected given underlying market trends and that short sellers are still prepared to take positions that require them to be identified. Nor have we seen obvious evidence of herding or short squeezes resulting from disclosures. Nevertheless we continue to monitor developments and gather statistical data.

(e) Disclosure thresholds

A transparency regime based on disclosures of short positions requires trigger thresholds to be set. The current UK proposals employ two thresholds – 0.25% for rights issues companies and 0.5% for all other listed companies. The CESR proposals add a third threshold – 0.1% for private disclosure to the regulator.

The precise disclosure level will always involve balancing the need to avoid having too many disclosures (if the level is too low) and not getting enough (if it is too high). The 0.5% standard for public disclosure helps to strike the right balance in this regard. We also believe that 0.1% is appropriate for so-called ‘private’ disclosure to the regulator.

We recognise and support a strong desire for as much international consistency on this issue as possible, given the considerable challenges for cross-border firms of complying with a range of different national standards. However, we also recognise that there are plausible arguments that the informational and deterrent benefits of public disclosure will be engaged at different levels depending on the size, liquidity and composition of the market in question. By definition, therefore, any thresholds agreed at international level will represent a compromise between the differing perceived needs of different markets.