

EU Financial Services Group Briefing

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Short Selling: FSA Publishes Feedback Statement

The FSA has published its Feedback Statement on Discussion Paper (DP) 17: Short Selling, and on which we published a newsletter in November. The FSA's position remains that short selling as an activity adds to market efficiency and liquidity, and that restrictions and rules imposed in other jurisdictions are not appropriate in the UK. Unsurprisingly, it has not proposed to make any changes to the FSA Handbook or publish a Consultation Paper on the subject.

Its principal proposals are, first, that CRESTCo publish regular securities lending and settlement failures data and, second, the introduction of measures to notify market participants where settlement problems are building in particular illiquid securities.

DP 17 set out the FSA's thinking on the practice of short selling and sought views on whether the current regulatory approach to it is suitable. Although the FSA's position on short selling is clear, the industry has been awaiting its verdict on this topical issue. Most, including industry bodies, will be relieved at the outcome. This may be particularly true of hedge funds, whose short selling activities have recently received increased regulatory scrutiny in the United States.¹

No Need for Regulatory Change

On the whole, respondents to DP 17 felt that the current regulatory approach to short selling is correct. Some argued that short sales regulation delays the market reaching its natural level and that without short selling during the long bull market the current bear market would have been more severe.

Although other jurisdictions, including the US, have addressed short term volatility issues associated with short selling through mechanisms such as 'tick' rules, most respondents

noted that these rules detract from market efficiency and are of questionable effectiveness.

A handful of respondents thought the current regime was not appropriate and the absence of disclosure of short positions increased the chance of market manipulation and collusion.

The responses confirmed the FSA's view that imposing controls on short selling is not the right way forward but that increased transparency is the answer.

Greater Transparency

The FSA considered that greater transparency for short selling might benefit market users and improve market confidence by providing information that would further facilitate efficient markets. DP 17 therefore invited comments on various options for increased disclosure of short selling.

The measures aimed at improving general transparency included marking and reporting short sales for cash equities, full disclosure of short positions in both cash and derivatives markets, and publishing data on securities lending. The first two options proved unpopular—mainly due to the significant costs to exchanges and market participants, but also as they were likely to encounter operational difficulties. The most popular and preferred approach (given that CRESTCo already collates this data) was the idea of publishing securities lending data.

The other transparency options proposed by the FSA were aimed at more specific disclosures. These included requiring disclosure of short positions beyond certain thresholds and of aggregate 'naked' short positions in individual cash equities, and requiring directors to disclose all short positions they take

¹ See, e.g., *SEC v. Rhino Advisors, Inc. & Thomas Badian*, Litigation Release No. 18003 (Feb. 27, 2003). On March 26, 2003, the SEC announced its scheduling of a roundtable discussion on a wide range of issues relating to the investor protection implications of hedge funds. The SEC's press release is available at <http://www.sec.gov/news/press/2003-40.htm>.

in the stock of companies on whose boards they sit. In relation to the first option, many respondents believed that publishing such information could be prejudicial to those holding large short positions by exposing their identity and increasing the risk of a 'bear squeeze'. Similarly, many believed that requiring disclosure of 'naked' short sales would disadvantage the seller's position and potentially present a risk to orderly markets. There was almost unanimous support for the third option: requiring directors to disclose short positions.

Settlement Risk

DP 17 also suggested some improvements for the settlement and delivery of equities where disruptions might be caused by 'naked' short sales in less liquid securities. It was suggested that this may be achieved by shortening the timeframe for requesting buy-in for securities or requiring guaranteed delivery of all short sales. There was little support for either of these options. The London Stock Exchange pointed out that 99% of equity transactions in the UK settle on the Intended Settlement Date. A number of respondents felt that the current regime was sufficient, whereas others suggested that settlement disruptions would be minimised by ensuring a properly functioning securities lending market and for adequate incentives to be in place within settlement arrangements to avoid fails.

The FSA's Preferred Approach and Next Steps

The FSA has agreed that the publication of stock borrowing data is a cost-effective way of improving market transparency. CRESTCo has indicated that it is prepared to publish stock lending data to this effect.

In relation to directors disclosing short positions, the FSA has reviewed the legal and regulatory position and concluded that short positions held by directors in companies on whose boards they sit are already disclosable and as such, no additional measures are required.

Despite the conclusions reached by respondents in relation to settlement risk, the FSA is still concerned about specific circumstances in which settlement disruption caused by 'naked' short selling may contribute to a potentially disorderly market or may impact negatively on investors. It considers the following measures will address these issues:

- that CRESTCo publish data on settlement failures in individual securities;

- the introduction of measures to notify market participants and warn investors in circumstances where settlement problems are building in particular illiquid securities; and
- shortening the buy-in timeframe for illiquid securities experiencing concentrated settlement failures (as opposed to the general proposal in DP 17).

CRESTCo has agreed to publish securities lending data and settlements failure data and expects to do so by late summer 2003. The London Stock Exchange and virt-x have agreed in principle to issue market status messages notifying their members when specified illiquid securities are experiencing a significant build up of settlement failures.

The FSA has indicated that the shortening of the buy-in timeframe for illiquid securities would be for the London Stock Exchange to implement, but expects the market would support such measures if properly targeted.

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