WILMER, CUTLER & PICKERING

EU Financial Services Group Briefing

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The UK Financial Services Authority Consults on Short Selling

BACKGROUND

The Financial Services Authority ("FSA") in the UK has responded to suggestions that short selling destabilizes markets and artificially exaggerates share price declines by issuing Discussion Paper 17 (DP 17). DPs are sometimes, though by no means always, a prelude to an FSA consultation on rule changes, but do not, themselves, propose any new rules. The FSA's position has always been, and 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. Importantly, they can find no evidence to link short selling trends to market falls, and indeed, evidence points to a recent decline in the volume of short selling despite falling markets. This runs counter to arguments put forward by some insurance companies, forced into selling stock to maintain solvency ratios, that the likes of hedge funds are destabilizing the market, increasing volatility by selling short.

This paper, then, does not address proposals to control short selling, but does consider possible methods of disclosure, as well as proposals to address certain settlement disruptions experienced when shorting. It attempts to dispel the image of short selling as a "speculative free ride" by setting out its intricacies, and reminding the reader that short sales are complex and costly, risky, and due to their increased use in a variety of scenarios, not always dependent on a falling market.

An important point to note is that the FSA does not receive direct data on short selling, and therefore relies on market intelligence and proxy data (for example, trends in derivative activity and stocklending information).

THE FSA'S ASSESSMENT OF CURRENT REGULATORY CONTROLS

DP 17 sets out the FSA's assessment of the existing rules which apply to short selling, starting from the standpoint that the FSA considers this activity beneficial to the market. However, the paper also acknowledges potential risks such as short term volatility and disorderly or manipulative trading. Other jurisdictions have addressed these issues through mechanisms such as "tick" rules, which have not, as yet, been adopted by UK exchanges. The purpose of these rules is to prevent a short sale being made at a price below the last traded price. DP 17 maintains the FSA's position that rules analogous to "tick" rules are unnecessary and do not necessarily solve the problems they seek to address, nor does the FSA perceive short selling, of itself, to be a manipulative practice that requires any regulatory controls beyond the existing market abuse regime.

SETTLEMENT RISK

DP 17 does not entirely discount the possibility of additional regulation to address the settlement risk that can occur when short sellers fail to deliver the securities that they hold (though it does point out that overall, settlement performance in the UK is good). The paper's suggestion in order to make the settlement process more robust is to consider whether guaranteed delivery should be required for short sales in order to overcome problems that have been caused in the past when short selling exceeds the available supply of shares. The paper also reports that UK exchanges are currently reviewing the existing time frames involved in requesting that the exchange buys in securities for delivery where delivery has not been made within the specified time period.

AN ARGUMENT FOR GREATER TRANSPARENCY

DP 17 advances possible regulatory changes in support of the FSA's belief that short sales contain information that is of value to other market users. The FSA does, however, acknowledge that the benefit of disclosure must outweigh its consequential burdens, and that any new arrangements should not compromise commercial confidentiality. This latter consideration means that any proposed reporting should be done on an aggregate basis.

DP 17 proposes three possible strategies:

1. All market participants should mark each short sale trade *made in the cash equity markets* and regularly report aggregate short sale positions to the exchanges and to the FSA for publication.

2. The marking and reporting of all short positions, whether in derivatives or the cash equity markets (which would catch data currently not collected on over-the-counter derivatives).

3. The use of data on securities lending as proxy data or short selling information (the paper reports that CRESTCo is working to provide more refined stock borrowing figures which strip out the possibility of double counting inherent in its current data capture system).

The paper also puts forward options for more specific disclosures (which could be pursued in conjunction with the above strategies):

- Requiring the disclosure of short positions beyond certain thresholds in line with the requirement under the Companies Act 1985 to notify a company of any holding of 3% or more of its shares.

- Requiring the disclosure of aggregate "naked" short positions in individual cash equities.

- Requiring directors to disclose all short positions they take, whether in cash equities or derivatives, in the stock of companies on whose boards they sit.

Comments are invited by 31 January 2003.

YOUR FEEDBACK

Short sellers in the UK markets all have an interest in FSA's deliberations. Discussion papers are a useful opportunity to shape a debate -- it is usually too late to do so once FSA has gone as far as issuing draft rules on a topic. If you disagree with any of FSA's premises or proposals, for example that disclosure is not necessary or would be unduly burdensome, let us know and we can help formulate a response to FSA.

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