



# Short selling: FSA feedback statement on DP 17

## Executive summary

The FSA has published its feedback statement on DP 17. The FSA has confirmed its view that short selling is a legitimate investment activity, that significant changes to the existing regulatory regime are not warranted but that increased transparency would be useful. The FSA proposes a market-based solution in the form of the publication of securities lending data through CREST. This will lead to greater transparency without imposing a burden on firms. The FSA also proposes a market-based solution to settlement issues, particularly with 'naked' shorts, involving the publication of information relating to settlement failures.

In October 2002, the Financial Services Authority (FSA) published discussion paper 17, *Short selling* (DP 17). DP 17 set out the FSA's thinking on the practice of short selling and looked at the adequacy of the current regulatory regime. Although short selling was considered to be a legitimate investment activity, concerns arose over the need for greater transparency. Greater transparency would benefit market users and improve market confidence by providing information that would facilitate efficient markets. DP 17 set out the results of the FSA's review and various options for increased disclosure.

- Marking and reporting short sales for cash equities. This would require market participants to mark each short sale transaction and report their aggregate short sale positions to the FSA and the exchanges.
- Full disclosure of short positions in both cash and derivative markets. This is more comprehensive than the first option, covering cash equities and derivatives.
- Data on securities lending as a proxy for short selling. This would involve the publication of this data, which CRESTCo currently has on its system.
- Disclosure of short sales beyond certain thresholds. This would require those holding short positions above a specified threshold to make disclosure to the company, which would then report to the market.
- Disclosure of 'naked' short sales (ie sales that have not been covered, generally through borrowing matching securities, at the time the sale was made).
- Disclosure of directors' short sales. Directors would have to disclose all short positions in the stock of their companies.

## Consultation feedback and FSA response

The FSA has now published a feedback statement summarising the comments received, its response to those comments and proposals for reform. The majority of the respondents supported an increase in general transparency and the most favoured option was the publication of securities lending data.

**Option 1: marking and reporting short sales for cash equities.**

**Option 2: full disclosure of short positions in both cash and derivatives markets.**

The supporters of option 1 believed it was unfair that information on short selling was only available to a few market participants. They considered that the proposed adoption of this measure would not put UK markets at any disadvantage, as there are similar provisions in place in other jurisdictions. The same could not necessarily be said for option 2, as the proposed requirements exceeded the current reporting requirements in other jurisdictions.

Concern was expressed that disclosure might result in short sellers being identified even if the information was published anonymously. Short sellers might subsequently make increased use of derivative products and possibly abandon short selling altogether to avoid any risk. This might be detrimental to liquidity and lead to over-priced stocks. In general, opponents considered both options to be unduly costly and burdensome to maintain with no proportionate benefits.

The FSA concluded that neither of the two options was justifiable. The cost to exchanges and market participants would be significant and monitoring compliance would be difficult. As to the frequency of disclosure, data aggregated monthly would be of no significant use to the market and any more frequent reporting requirement would be unduly onerous to firms. The FSA expressed further concern that the introduction of disclosure requirements at this time would have a negative effect on the market and that a system requiring frequent disclosures would increase the risk of upward price manipulation. (This is because the risk of squeezes to which short sellers could be exposed is real enough to discourage short selling.) In reaching its conclusion, the FSA has taken into account the real concern and possibility of migration of short sellers in the light of increased disclosure requirements in the UK compared to other jurisdictions.

**Option 3: data on securities lending as proxy for short selling.**

This was the preferred option and is discussed later in this briefing.

**Option 4: disclosure of short sales beyond a certain threshold.**

Those in favour of this option believed that such disclosures would provide companies with important information regarding how their shares were held and provide parity with reporting requirements for long positions. However, a common argument against this option was that the disclosure of short positions had nothing to do with corporate control issues because short sellers did not receive voting rights. The motives for such an option were thought questionable; the information might well be used to squeeze short sellers out of the market. There could be a negative impact on the market and, furthermore, price distortion. Moreover, the introduction of disclosure requirements could lead to market participants building their stock holding to just below the disclosure threshold and then using synthetic shorts in order to avoid disclosure.

The FSA considered that this option would not provide sufficient benefit to the market to justify its implementation. The disclosure requirements would be

easy to avoid. Disclosure requirements of short selling would not be compatible with the existing Companies Act disclosure requirements and devising a separate market-based framework for disclosure of long and short positions would be extremely costly.

**Option 5: disclosure of short sells in specific situations.**

One-third of respondents said that naked short selling represented a risk to settlement systems and to orderly markets and felt that disclosure would improve transparency and prevent abuses. However, opponents believed disclosure would expose short sellers to the risk of short squeezes and that the implementation and maintenance costs were unjustified.

The FSA agreed that naked short selling could, in certain circumstances, contribute to a false or disorderly market. However, it would not be sensible to introduce measures that would affect the entire market when only a few participants were responsible for the problems associated with failing to cover naked short sales. The FSA nevertheless would like to address the problems that naked short selling can cause and has proposed a package of several initiatives that will address settlement problems created by naked short selling, particularly in illiquid securities (see below).

**Option 6: director dealings in short sales.**

Respondents favoured requiring disclosure of directors' short positions. However, the FSA considered the introduction of additional disclosure requirements as unnecessary, as short positions held by directors are already disclosable.

**Publication of securities lending data**

The FSA believes that publication of stock borrowing data is a cost effective way of improving market transparency, as it is already collated by CRESTCo. Moreover, regular publication can over a period of time provide an overview of short selling trends. The FSA further considered that provided sufficient customer confidentiality protections exist, legitimate commercial interests should not be jeopardised by publication.

CRESTCo has stated that it is prepared to publish stock lending data and expects to be in a position to do so by

late summer 2003. The FSA is in discussions with CRESTCo over ways the data can be processed in order to provide useful information to the market. The intention is that the published data will be aggregated per security without reference to pricing, and will be published with an explanation of the information contained and a warning of the limitation of interpreting that data as a proxy for short selling (stock is borrowed for a number of reasons other than to cover a short sale, for example to cover a settlement fail). The FSA does not see the case for proceeding with any further general transparency measures at present.

## Settlement

DP 17 also discussed settlement concerns arising from naked short positions in less liquid securities. The FSA has rejected the imposition of a blanket requirement for short sales to be transacted with guaranteed delivery. Instead it proposes a package of measures designed to help improve settlement and delivery in illiquid securities:

- CRESTCo will publish data on settlement failures for those securities with the highest proportion of failures;
- the London Stock Exchange and virt-x will publish market status messages notifying members about securities experiencing a significant proportion of settlement failures;
- the FSA is discussing a range of market-based methods with exchanges and trade associations to enable customers to become aware of a significant build-up of settlement failures (the FSA's preferred option is for brokers to warn their customers);
- the FSA is discussing with the London Stock Exchange the possibility of shortening the buy-in timeframe for illiquid securities experiencing a significant build-up of settlement failures; and
- the equity exchanges will keep penalties for buy-in under review.

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