UK FSA Proposes Short Selling Disclosure Requirement for All UK Stocks

By William Yonge (Proskauer Rose LLP)

Last September the UK Financial Services Authority (the "FSA") introduced a temporary ban on the short selling of specified UK financial stocks and required disclosure to the market of net short positions in excess of 0.25% of the issued share capital of those UK financial sector companies. The prohibition on short selling was a temporary measure, introduced by the FSA in an effort to stabilise the volatile financial markets and attempt to release some of the downward pressure exerted on the UK markets, particularly financial stocks; the FSA was concerned by the heightened risk of market abuse and disorderly markets posed by short selling. The temporary ban expired on 16 January 2009; however, in order to mitigate the potential risk of the sharp share price declines in individual banks returning, the FSA decided to retain the disclosure obligations until 30 June 2009. When it imposed the ban, the FSA announced that it would conduct a comprehensive review of short selling in the UK. This review has now been completed and, in Discussion Paper 09/1 issued on 6 February 2009 (the "Discussion Paper"), the FSA has set out its analysis and initial conclusions inviting comments by 8 May 2009. The FSA has concluded that no permanent restrictions on short selling should be introduced as the benefits of short selling, such as price efficiency and liquidity, outweigh the disadvantages. However, the FSA has also proposed that a general short selling disclosure requirement should be introduced permanently for all net short positions of 0.5% or more of the issued share capital of any company listed on a UK exchange. The FSA believes that international consensus on the key issues relating to short selling is crucial and reiterated its desire use the feedback to its proposals to "inform the international debate".

The FSA makes clear that it is prepared to reintroduce the short selling prohibition, without consultation, should circumstances require it and will review whether the current disclosure requirements will be extended nearer the 30 June 2009 deadline.

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Impact of Short Selling

The Discussion Paper examines the pros and cons of short selling. Whilst acknowledging that short selling is regarded as a controversial technique, particularly in falling markets, the FSA reiterates that it regards short selling as a legitimate investment technique in normal market conditions and considers that short selling contributes to the efficient functioning of the market, enhances liquidity by increasing the number of potential sellers in the market and enhances price efficiency in normal conditions. However, the Discussion Paper also notes that short selling can lead to the following four potential problems:

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Market Abuse

Short selling can be used abusively to create misleading signals about the supply and correct valuation of a stock. Also, short selling can be used in conjunction with scaremongering tactics to push down the price of a stock being shorted. The potential for abuse is greater for naked short selling than for covered short selling because for covered short selling the requirement to 'cover' inhibits both the speed and extent of the short selling. However, naked short sellers can sell as quickly as they can find a buyer and can short sell over 100% of a company's issued share capital.

Disorderly Markets

Short selling can convey a signal to the market that a company is overvalued and, if investors act appropriately, this improves the accuracy of the value of the stock in ques-

FSA Short Selling, continued on page 17

FSA Short Selling *(from page 16)*

tion. However, if investors overreact the price decline may be excessive and may spread to related stocks. This "contagion effect" can ultimately result in disorderly markets and the FSA confirms that it took the view in September 2008 that market conditions had led to an unacceptable risk of abusive behaviour and resultant disorderly markets through short selling.

Transparency Deficiencies

Information asymmetries between informed short sellers and uninformed market participants could result in price inefficiency. The FSA considers that information about the aggregate short position in a single stock could help the market judge the extent to which short selling is driving the price of a particular stock. However, the FSA notes that studies have shown that excessive transparency can reduce liquidity because traders are unwilling to reveal their trading strategies.

Settlement Issues

Naked short selling gives rise to a risk of settlement failure where the seller may be unable to deliver stocks to the buyer. The FSA has made it clear previously that short selling without any intention or reasonable plan to settle the short position will be considered to be market abuse and the FSA has previously taken enforcement action on this issue. It was noted that mechanisms already exist in practice to mitigate the risk of settlement failure, such as the London Stock Exchange ("LSE") having the capacity to instruct members that short sell to source the stock in the open market to enable settlement. Also, at the request of the buyer, the LSE may itself intervene to source the stock to facilitate the settlement process.

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The FSA outlined in the Discussion Paper that it considered that there were two main strands to mitigate the potential negative effects of short selling:

- introducing potential constraints on short selling; and
- enhanced transparency.

FSA Short Selling, continued on page 18

FSA Short Selling *(from page 17)*

Regulatory Options: Potential Constraints on Short Selling

A range of potential constraints on short selling are canvassed in the Discussion Paper, as follows:

- Prohibit short selling of all stocks;
- Prohibit naked short selling;
- Prohibit short selling of financial sector stocks;
- Prohibit short selling of companies engaging in rights issues;
- Prohibit short selling by underwriters of rights issues; and
- Prohibit short selling where there is urgent need.

In the Discussion Paper, the FSA discusses the use of "circuit breakers" and "tick rules" which may prevent or impede short selling if certain pre-conditions are met or not met.

A circuit breaker involves a suspension of trading in a share whenever there is an abnormal rise or fall in its price. Traditionally the UK has not used circuit-breakers. However the London Stock Exchange operates automatic execution suspension periods or AESPs which are designed to provide a pause in trading in the form of a short intra day auction lasting about five minutes. The FSA considers these arrangements are sufficient and the imposition of additional regimes would not be proportionate.

There are two types of 'tick' rule. An up-tick rule provides that the last sale must have been at a higher price than the sale preceding it before a share can be short sold. A zero-plus tick rule provides that if the last transaction price is unchanged but higher than the preceding sale then the stock can be shorted. Tick rules allow relatively unrestricted short selling in a flat or advancing market, but prevent short selling at successively lower prices. So they mitigate the risk that short selling is used to drive down share prices and prevent short sellers from accelerating a successively lower prices to be established by long sellers.

The UK has no direct experience of tick regimes but the US Securities and Exchange Commission (SEC) carried out a comprehensive study into the impact of its up-tick rule which had been in operation for approximately 70 years. This exercise led to the conclusion that the SEC "should remove price test restrictions because they modestly reduce liquidity and do not appear necessary to prevent manipulation". Another key finding was that there was no evidence that there was an association between extreme price movements and the absence of a tick regime. So in 2007 the SEC abandoned its up-tick rule.

The FSA agrees with the SEC that tick rules provide limited protection as regards the negative effects of short selling and, at most, simply act to decelerate share price declines. What does seem clear to FSA is that tick rules come at substantial cost if none of the necessary infrastructure is already in place. Most significantly, in order to be effective, tick rules require a marking (or flagging) regime to be operated by market participants, exchanges and clearing and settlement houses alike. In addition, they have the potential to eliminate legitimate short selling strategies, making the price formulation process more inefficient and reducing liquidity. Additionally, given the increasing fragmentation of trading venues and the absence of a consolidated tape, the cross-exchange consistent application of such a rule would carry with it substantial compliance costs. Finally, tick rules apply only to the cash markets and there are many ways of achieving the same effect by use of derivatives.

In conclusion FSA does not consider a 'tick' rule to be a proportionate measure and does not propose adopting one.

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At this stage, the FSA has concluded that direct constraints on short selling are not currently justified and would be a disproportionate response in light of the beneficial functions of short selling outlined above (notably the promotion of price efficiency and providing liquidity). Furthermore, the FSA has concluded that the actual cost of introducing any permanent restriction on short selling in the UK would outweigh the benefits.

Regulatory Options: Enhance Transparency

The FSA considers that the two principal reasons for improving the transparency of short selling are:

- providing additional valuable information to the market; and
- mitigating some of the problems associated with short selling.

Disclosure of short positions plays an important role in conveying a signal to the market that a firm is overvalued and thus will assist with pricing efficiency. The FSA stated that market participants had indicated that there would be value in increasing transparency for short selling on an ongoing basis. Such a disclosure requirement could partially address some of the issues associated with abusive short selling as it would help in detecting short selling that is being used to commit market abuse, one of FSA's top priorities, so any mechanism that might help reduce

FSA Short Selling, continued on page 19

FSA Short Selling *(from page 18)*

its incidence should be considered seriously. Furthermore, greater transparency could help identify when investors are acting irrationally over abrupt price changes and ongoing disclosure requirements would give the FSA more advance warning of conditions in which it may have to consider regulatory intervention. Finally, the FSA recognises the potential deterrent effect that disclosure obligations will have on those considering aggressively taking large short positions which may contribute to market volatility, particularly in times of market turbulence.

The Discussion Paper acknowledges that there are potential disadvantages in increasing transparency. If any new transparency obligations had the effect of significantly reducing the overall level of short selling then this would have an impact on price formation and liquidity in general. Other downsides include the 'herding effect' of other short sellers following a 'big name' short seller who has disclosed a significant short position to the market. Lastly, the FSA is aware of the direct financial costs to firm that implementing and operating systems in order to comply with the disclosure obligations will create.

The FSA concludes that the benefits of disclosure obligations outweigh the costs and that experience of the existing temporary short selling disclosure requirements has indicated that some short sellers are deterred from holding positions above disclosure thresholds.

The FSA acknowledges that the different disclosure measures on short selling adopted by regulators around the world have raised significant compliance problems for those firms operating cross-border. This patch-work process has led to market participants encountering significant costs in having to comply with the variety of different regimes in different jurisdictions. The Discussion Paper will be used to "inform the international debate" and it was noted that both the International Organisation of Securities Commissions (IOSCO) and the Committee of European Securities Regulators (CESR) both currently have working groups on short selling.

FSA Proposals Relating to Enhanced Disclosure Obligations

The FSA proposes to implement a permanent disclosure regime for all stocks listed on a UK exchange which is similar to the temporary regime currently in force for specified financial stocks only. The FSA considers there are two approaches that could be used to increase transparency in short selling (which are not necessarily mutually exclusive):

(i) disclosure of aggregate short positions for a particular security; and

(ii) disclosure of significant individual short positions either privately to the regulator or publicly to the market as a whole.

Both approaches provide benefits, however, the FSA is of the opinion that the costs of implementing an aggregating regime would be extremely expensive and far higher than those involving disclosure of significant net short positions. Although aggregate short position reporting is used in the US, the FSA is of the opinion that such

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a regime would not provide additional value in the UK environment because equivalent information is already available to a large degree via the stock lending data. Also, there is an issue as to how much more precision would actually be obtained by implementing such a regime as the mechanics of aggregation introduce inherent imperfections to the data. For example, when an order is placed to

FSA Short Selling, continued on page 20

FSA Short Selling *(from page 19)*

sell a share, the order placer has to know whether it is a short sell or a long sell. This may not be straightforward for fund managers or other large entities that hold shares in different parts of their organisations, and one arm of the organisation may hold long positions in a certain stock while another arm may hold short positions.

Disclosure Thresholds

The Discussion Paper proposes that there should be one threshold applied to all UK stocks traded on prescribed markets in order to avoid making the regime too complicated. The temporary short selling measures were based on a minimum threshold of 0.25% of the issued share capital of a company, however, this was deemed not to be an appropriate threshold as there are varying degrees of size and liquidity to consider. The FSA's analysis shows that when firms made their first short selling disclosures to the market under the temporary measures, the mean short position size was approximately 1.05% and the median short position size was approximately 0.51%, indicating that these sizes may be meaningful to the market. This analysis was, of course, based on the current measures, which apply only to UK financial sector companies. Taking into account variations in the size of companies' market capitalisation, liquidity in the markets in companies' shares, and the sizes of positions that would be disclosed, the FSA concluded that 0.50% of a company's issued share capital could represent an appropriate threshold for triggering disclosure obligations for net short positions.

Subsequent Trigger Points

It is imperative that the disclosure regime tracks changes in significant short positions as well as identifying when they reach and fall below the initial disclosure threshold. Accordingly, the Discussion Paper proposes that, if the initial threshold is 0.5%, additional disclosures should be fixed in increments of 0.1% of the issued share capital of the company. This is the same as for the temporary measures.

Market Maker Exemption

As short positions entail more risk for market makers than long positions (which they have to disclose, albeit at higher thresholds than those applicable to other firms), there is a proposed exemption for market makers. Trading in circumstances other than genuinely for the provision of liquidity is not exempt.

Credit Default Swaps and Rights Issues

The FSA does not propose extending any enhanced disclosure obligations to credit default swaps because it already receives CDS transaction reports and under the proposals above would receive disclosure of significant short positions. Also, the FSA does not intend amending the existing disclosure requirements in relation to the short selling of shares during rights issues which begins at 0.25%. However, the FSA has left the door open for the introduction of industry guidance to attempt to deal with some of the risk generated by short selling rights issues.

Conclusion

Whilst the FSA is taking its share of the blame for failings in banking regulation and accordingly is under some political pressure to change and raise its game, in the area of short selling the FSA is certainly leading from the front in promoting debate and seeking an international approach. The consultation period on the Discussion Paper ends in May 2008. FSA will then look to publish a Feedback Statement describing its longer term policy on the regulation of short selling. ❏