Feedback Statement

FS09/4

Financial Services Authority

Short selling: Feedback on DP09/1

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FSA®

Contents

This Feedback Statement reports on the main issues arising from Discussion Paper 09/1: *Short selling*.

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1 Overview

Purpose

1.1 In this paper we summarise and respond to the feedback we received to our proposals on the regulation of short selling in our DP9/01 *Short Selling*, published in February 2009. This followed our comprehensive review of policy on short selling.

1.2 Given that important international initiatives on short selling remain ongoing, we do not plan to publish any proposed rule changes at this stage. Instead, we are using this Feedback Statement (FS) to set out our policy stance in light of the responses received and relevant developments since we published DP09/1.

Background

1.3 The background to the review was the emergency measures we introduced in September 2008 in relation to stocks in UK financial sector companies (the Measures). We took these Measures because of the destabilising effects in the extreme conditions prevailing and concerns about the potential for market abuse resulting from short selling. The Measures effectively banned the active creation or increase of net short positions in the stocks of UK financial sector companies (the Ban) and required disclosure to the market of significant short positions in those stocks (the Disclosure Obligation). We introduced the Measures without consultation as we considered there was an urgent need to do so, but we gave them a limited life and they were set to expire on 16 January 2009.

1.4 Following a short consultation in January 2009 we allowed the Ban to expire but extended the Disclosure Obligation until 30 June 2009. On 1 June 2009 we published a Consultation Paper (CP09/15, *Extension of the short selling disclosure obligation*)[1] which set out our proposal to extend the Disclosure Obligation in its current form without time limit. However, we stated we did not intend the Disclosure Obligation to apply permanently in its current form and that we intended

1 www.fsa.gov.uk/pages/Library/Policy/CP/2009/09_15.shtml

eventually to replace it with a permanent regime. We implemented the proposals in CP09/15 after publishing Policy Statement PS09/10, *Extension of the short selling disclosure obligation – feedback to CP09/15*.[2]

1.5 We were clear in DP09/1 that we considered it highly desirable to find an international consensus in this area and, for that reason, we chose not to make any definitive proposals at that time. There have been several significant developments in the international context since then. Firstly, in June 2009, the International Organisation of Securities Commissions (IOSCO) published a Final Report (*Principles for the Effective Regulation of Short Selling*) outlining four principles for regulating short selling (the Principles). The Principles are high level, but provide a valuable framework to guide the international regulatory community in developing its approach.

1.6 Secondly, in July 2009, the Committee for European Securities Regulators (CESR) regime published a Consultation Paper on a Proposal for a Pan-European Short Selling Disclosure Regime[3] (the CESR CP). The proposals in the CESR CP were very similar to those in DP09/1 but, in addition to public disclosure at individual net positions of 0.5% and above, proposed that there should be confidential disclosure to the regulator at 0.1% with subsequent incremental disclosures at 0.1% thresholds. The CESR proposals would apply to short positions in all EEA stocks. Consultation on the CESR CP closed on 30 September and a Final Report is expected from CESR before the end of 2009.

Summary of issues raised by respondents and our response

1.7 There were 54 responses to DP9/01, including 17 from trade associations (or trade association coalitions) representing the views of their members. Most of the other responses came from authorised firms, but there were several responses both from non-authorised firms and individuals. We thank respondents for their comments.

1.8 There was strong support from respondents that short selling should not be subject to any permanent ban and most also agreed that the FSA should not introduce other constraints, such as circuit breakers and up-tick rules. There was widespread support for enhanced transparency. The most notable areas of contention regarded public disclosure of individual positions (particularly because of concerns about 'herding' behaviour and loss of intellectual property rights) and the levels at which disclosure thresholds should be set. There was also strong support for our stance of seeking cross-border consistency.

1.9 Our current thinking is that no major aspects of the proposals for a disclosure regime should change. Nevertheless, we remain committed to proceeding on as wide an international basis as possible and to achieving a harmonised regime within Europe. Accordingly, in light of the CESR proposals, we will keep open the possibility of requiring 'private' disclosure to the FSA at a lower level.

2 www.fsa.gov.uk/pages/Library/Policy/2009/09_10.shtml

3 CESR/09-581, CESR Proposal for a Pan-European Short Selling Disclosure Regime.

1.10 In addition, we do believe that if we were to implement such a two-tier system we could re-consider whether a separate lower threshold for rights issue companies were necessary, particularly given some of the responses we received on that issue. Consideration could be given to exploring whether there may be ways of providing additional protection here, e.g. by making use of any position data disclosed privately to regulators. However, at this stage we are not departing from the current proposal for a lower threshold.

Who should read this Feedback Statement?

1.11 This Statement will be of interest to UK financial sector companies, short sellers of stock, consumers, other firms and trade bodies and their advisers.

Structure of this paper

1.12 Chapter 2 provides feedback on the responses to our proposals regarding potential direct constraints on short selling and Chapter 3 provides feedback on the responses to our proposals for enhanced transparency for short selling. Annex 1 lists non-confidential respondents.

2 Feedback on proposals on direct constraints

2.1 This chapter sets out our feedback on the responses received to our proposals for potential constraints on short selling, set out in Chapter 4 of DP 09/1. We asked:

> Q1: What are your views on the costs and benefits of a blanket short selling ban? Where possible please quantify.

2.2 All but one of the respondents that addressed this question agreed with our analysis that the costs of a blanket ban on short selling would outweigh the benefits. Many pointed to the positive role played by short selling in terms of aiding liquidity and pricing efficiency and facilitating hedging. Although some respondents also referred to the compliance costs of a blanket ban, all believed that the really significant costs were reduced liquidity, higher bid-offer spreads, reduced volumes, reduced ability to hedge and, ultimately, increased transaction costs.

2.3 The overwhelming consensus that emerged was that the costs of a blanket ban on short selling would be very high compared to the benefits and it would therefore be disproportionate.

Our response: In DP09/1 we set out the full extent of the cost benefit analysis we conducted then. We still consider these results to be valid and believe strongly that, in normal market circumstances, the costs of a blanket ban on short selling far outweigh the benefits. This position is predicated on there being an effective disclosure regime and the benefits that brings with it.

> Q2: Do you agree that there should not be a ban on all forms of short selling?

2.4 Only one respondent supported a blanket ban on short selling, with all the others who addressed the question agreeing with our stated position that there should not be a blanket ban. Many of those respondents commented on the positive role that short selling plays and its contribution to market efficiency by providing liquidity and opportunities for risk management. There were several references amongst the responses to academic studies suggesting that the temporary bans introduced by regulators around the world had had an adverse impact on market quality, by

increasing both spreads and volatility in the share prices of the affected stocks. A couple of respondents commented that while they did not support a blanket ban, this view was contingent on there being sufficient alternate regulation.

Our response: For the reasons set out in DP09/1 – and in view of the overwhelming support for our stated position – we do not intend to impose a blanket ban on short selling. We continue to hold the view that short selling plays an important and positive role in normal market conditions and we are convinced that a blanket ban, other than in emergency circumstances, would have an undesirable negative impact on market efficiency.

Q3: Do you think any further measures are necessary to deal with naked short selling. If so, what is required and why?

2.5 There were mixed views on this issue, but most of the responses we received to this question supported our opposition to a ban on naked short selling. Some felt that the main risk associated with naked short selling – settlement failure – was not a concern in the UK.

2.6 A number of respondents stated that any concerns about settlement failure could, in any event, be addressed through the settlement and buy-in structures already in place in the UK. One or two respondents felt that the loss of liquidity and consequent impact on the price of borrowing that would arise from a ban on naked short selling could not be justified. A few respondents, while not advocating a ban, believed that consideration should be given to stricter settlement discipline.

2.7 Another small group held the unequivocal view that naked short selling should be banned, arguing that it was manipulative in itself. A slightly larger group did not advocate a ban, but commented on the importance of distinguishing clearly between abusive and non-abusive forms of short selling.

Our response: For the reasons set out in DP09/1 – and in light of the majority support received – we do not propose introducing a general ban on naked short selling.

We do not consider naked short selling to be illegitimate activity in itself: it can provide valuable liquidity to the markets and is necessary as part of market making activity. We have not seen persuasive evidence that it poses an unacceptable risk of settlement failure and, insofar as it does create any such risk, we believe that the robust settlement and buy-in requirements that currently operate in the UK provide adequate mitigation. We agree with the points raised in response to DP09/1 that a ban on naked short selling could also potentially adversely impact liquidity and create too much demand in the stock-lending market.

However, as we have previously made clear, we would be concerned about any naked short selling carried out with no intent or reasonable plan for delivery of the shares on the intended settlement date, and would be prepared to pursue action against such conduct.

Q4: Should short selling of financial sector stocks be banned permanently?

2.8 Very few respondents believed there should be a permanent ban on the short selling of financial sector stocks. All of the remaining respondents that addressed this question agreed with our position that there should not be such a ban.

2.9 A lot of respondents made the point that the financial sector, or indeed any other sector, should not be treated differently. Some said that the volatility in financial sector stocks experienced last autumn stemmed from their underlying economic fragility rather than short selling. Others drew attention to the economic benefits of short selling.

2.10 Significantly, a small number of respondents did believe there was a case for banning short selling of financial sector stocks in emergency circumstances, especially where the issuer is systemically important.

Our response: In light of the strong support for our proposal and for the reasons set out in DP09/1, we do not intend to permanently ban the short selling of financial sector stocks. We are, of course, conscious of the particular vulnerability of the financial sector in recent times and of the volatility in the markets for shares in financial sector companies.

We also note that the linkage between share price and consumer confidence is especially strong in relation to financial institutions. However, we believe that market conditions have stabilised and improved greatly since autumn 2008 and do not see a case for permanently banning short selling of financial sector stocks.

Q5: Do you agree that, subject to having a satisfactory disclosure regime, we should not ban short selling of the stocks of companies engaging in rights issues?

2.11 There was overwhelming support for our proposal that the short selling of stocks of companies engaging in rights issues should not be banned. Of the respondents who addressed this question, only a handful believed there should be such a ban and just one of these supported a blanket ban on all short selling. Some respondents referred to the costs of a ban and the importance of market participants being able to hedge the risks they are exposed to when taking up a rights issue.

2.12 A significant group indicated that they did not support a ban on short selling the stocks of companies engaged in rights issues as long as there was adequate transparency in these circumstances. Quite a few respondents stated that they felt that the market abuse regime, as it currently stands, is adequate to deal with the risks of abusive behaviour in relation to companies engaged in rights issues.

Our response: We acknowledge that companies are more vulnerable than usual during the period during which they are engaged in a rights issue but, for the reasons set out in DP09/1 and because of the overwhelming support that our proposals received, we do not plan to introduce a ban for such circumstances.

We believe that any such ban, other than in specific urgent circumstances, has the potential to have an adverse impact on the rights issue process. We agree that there should be appropriate transparency of short selling during rights issues and this is discussed in the response to feedback on Q20 below.

Q6: Do you agree that we should not ban short selling by underwriters of rights issues (of the shares they are underwriting for the duration of the underwriting process)?

2.13 A number of respondents chose not to address this question directly. Of those that did comment, a few believed that short selling by underwriters should not be allowed and one believed that short selling by sub-underwriters should not be allowed.

2.14 However, the overwhelming majority agreed with our position that short selling by underwriters of rights issues should not be banned. These respondents made a range of significant points. A common observation was that short selling by underwriters of rights issues was a legitimate hedging technique and a ban on it might adversely affect the price and, ultimately, availability of capital. Many of those respondents thought that existing arrangements, if upheld, provided adequate constraints.

2.15 A small group of respondents referred to the importance of contractual arrangements in controlling the practice and some referred to the FSA-facilitated guidance on that issue that will be published by market participants. They also referred to the role that disclosure plays in constraining unwanted consequences in this context.

Our response: We recognise that short selling by underwriters of rights issues serves a legitimate and valuable purpose in normal market conditions. We also acknowledge that a ban on the practice could have an unwanted adverse impact on the availability of capital and the success of rights issues. Accordingly, for the reasons set out in DP09/1 and in view of the very strong support for our proposals, we do not intend to impose a permanent ban.

We would, however, encourage market participants acting as parties to a rights issue to take into account the non-prescriptive guidance that is being developed following recommendations from the Rights Issue Review Group[4] and which will be published in due course.

Q7: Should we intervene to ban short selling on an emergency basis where necessary e.g. to combat market abuse and/or to maintain orderly markets?

4 *A Report to the Chancellor of the Exchequer*: by the Rights Issue Review Group, November 2008

2.16 Most clearly favoured our proposal that we should have the ability to intervene to ban short selling on an emergency basis, but some were clearly opposed to it. In addition, a range of interesting reservations and caveats were expressed.

2.17 A number of respondents indicated that emergency intervention should only take place in exceptional circumstances and one or two identified the importance of regulatory intervention not amplifying market disorder. In this vein, some respondents commented that they believed that the evidence showed that the temporary ban introduced in 2008 had had a negative impact on market quality and, ultimately, had not addressed the perceived problems (or underlying causes of those problems).

2.18 Others pointed out that any emergency intervention should have clear time limitations and three mentioned the need for appropriate exemptions (e.g. market makers). There was also reference in one or two responses to the need for clear and objective criteria governing intervention but there were also balancing views that the FSA needed flexibility and should not be unduly constrained in when it could choose to intervene. One respondent observed that we should only intervene to ban short selling in order to prevent market disorder and that any emergency powers should not be based in the market abuse regime but should have a clear and separate statutory footing.

Our response: Since we first introduced a temporary ban on the short selling of UK financial sector stocks on 18 September we have been clear that, while we regard short selling to be a legitimate technique in normal market conditions, we should be able to ban it (either across the board or on a targeted basis) if emergency circumstances so require. A large majority of respondents agreed with that and accordingly, for the reasons set out in DP09/1, our position remains that we should have the ability to intervene to ban short selling on an emergency basis.

Nevertheless we are mindful of the potential costs of a ban and can assure market participants that we would not impose one other than in extreme circumstances and after careful consideration. As regards the powers under which we could take action, the government is currently consulting on proposals to give us discrete powers under which we could impose an emergency ban or other temporary controls on short selling.[5]

Q8: Do you agree that no additional circuit-breakers should be introduced?

2.19 The vast majority of the respondents who answered this question directly agreed with our view that no additional circuit-breakers should be introduced. A number stated that they felt that existing arrangements such as Automated Execution Suspensions (AESPs) and Price Monitoring Executions (PMEs) were adequate, although some thought it would be valuable to review the arrangements in venues other than the LSE.

2.20 There were a few comments questioning the effectiveness of circuit-breakers and one or two comments suggesting that they can have a negative impact by exacerbating market distortion. A few respondents disagreed with our proposal, stating that

5 Cm 7667, *Reforming Financial Markets*, paragraphs 4.75–4.83

circuit-breakers were appropriate so long as they were well defined and had clear triggers (one respondent suggested that there should be multiple thresholds triggering differing degrees of suspension).

Our response: For the reasons set out in DP09/1 and in view of the very strong support for our position we do not plan to introduce additional circuit-breakers to constrain short selling. We do not consider them to be a particularly effective means of mitigating the potential risks posed by short selling and, insofar as they do have a role to play in this context, we consider arrangements currently in place (e.g. AESPs and PMEs) to be adequate.

Q9: Do you agree that we should not introduce a tick-rule?

2.21 Respondents who addressed this question gave near-unanimous support for our view that a tick-rule should not be introduced. A very small number of respondents believed that a tick-rule should be introduced with one giving the perceived likelihood of such a rule being introduced in the US, and the importance of international convergence, as their principal reason. Many respondents stated that the costs and benefits of a tick rule did not add up, pointing out that because no marking or flagging infrastructure currently exists in the UK, implementation would be very costly. Many respondents questioned the effectiveness of tick-rules, suggesting that they only temporarily decelerate price declines and pointing out that, in the US, they are confined to the cash markets and therefore would not address all short selling.

Our response: For the reasons set out in DP09/1 and in view of the near-unanimous support for our position, we do not intend to introduce a tick rule. Aside from the fact that the appropriate infrastructure for such a regime does not currently exist in the UK and would be costly to introduce, we are not convinced that a tick rule would be particularly effective. Its applicability appears to us to be limited – there are clear difficulties in applying it to short selling effected through derivative transactions – and there is also evidence to suggest that it only achieves temporary deceleration of price decline at best.

Q10: Are there any other direct constraints on short selling that you think ought to be considered? If so, please provide information regarding their costs and benefits.

2.22 Respondents did not suggest any other constraints on short selling that should be considered. However, two took the opportunity to state their belief that restrictions on stock lending should not be considered or, at very least, should be approached with great caution. These respondents pointed to the valuable role in the markets played by stock lending, the fact that it is an inaccurate proxy for short selling and the fact that short selling is only one of many reasons for borrowing stock.

Our response: We do not think any direct constraints on short selling are justified at this time and agree that restrictions on stock lending would be a sub-optimal means of dealing with problems caused by short selling. However, as stated in DP09/1, we continue to believe that extreme market conditions could re-emerge where the risks posed by short selling warrant some form of emergency intervention.

While this is likely to take the form of a prohibition (either general or targeted) it could take the form of some other type of direct constraint, such as trading suspensions, or it could take the form of enhanced disclosure (beyond the requirements of any permanent general regime).

3 Feedback on proposals regarding enhanced transparency

3.1 This chapter sets out our feedback on the responses received to our proposals regarding options for enhanced transparency of short selling, set out in Chapter 5 of DP09/1. We asked:

> Q11: Do you agree, in principle, that the benefits of transparency around short selling outweigh the costs?

3.2 There was broad support for our position that the benefits of transparency, in principle, outweigh the costs, with most respondents who addressed this question agreeing unequivocally. A number, while agreeing with the principle of enhanced transparency, stated that the benefits and costs depended on the nature of any disclosure regime. Some indicated that the benefits of disclosure would increase with cross-border consistency; others said that aggregation of data would enhance benefits and another group stated that public disclosure of identified short sellers would mean that costs outweighed benefits. A few respondents felt that the case in favour of enhanced transparency was not proven and needed further analysis. A similar number did not support it in principle.

Our response: For the reasons set out in DP09/1, we continue to hold the view that, in principle, the benefits of transparency around short selling outweigh the costs. However, we also agree with those respondents who said that this principle was not inviolable as the benefits of transparency will depend on the nature of any disclosure regime.

> Q12: If disclosure obligations are introduced, do you agree that those obligations should apply to all equities and their related instruments rather than be limited to certain sectors or companies?

3.3 There was strong support from respondents for our proposal that any disclosure obligations should not be limited to certain sectors or companies. A few suggested that it was essential for public confidence not to discriminate between sectors and another stated there should not be any suggestion that one sector is being afforded preferential status. Others said the compliance costs of a disclosure obligation that

applied across the board would be less than if it applied on a sectoral or company-specific basis. And one respondent thought that a limited obligation could lead to displacement of abuse to other sectors.

3.4 However, a couple of respondents felt that positions in collective investment schemes should not be reportable. In addition, a few respondents agreed, in principle, with our position but felt that, in practice, it had difficulties – either in terms of the practicalities of aggregation or in terms of the cost benefit analysis. A further respondent felt that the nature of any disclosure obligation should vary depending on the nature of the regulatory concern at stake. Finally, there was a small number of respondents who overtly disagreed with our position. One felt that disclosure in relation to all sectors would be too burdensome and costly and that the huge amount of data that would be received would make consolidation difficult. Another believed that disclosure should only apply to those sectors heavily dependant on public confidence, such as the banking sector; and a third expressed the view that because of the negative impact of disclosure, any obligation should be limited to the smallest possible sector.

Our response: As we noted in DP09/1, the potential risks posed by short selling are not limited to any one sector or set of companies, but apply across the board. Accordingly, we think that the benefits of enhanced transparency, both in informational terms and in terms of the constraints on aggressive short selling it provides, apply across the board. There was strong support for this view from respondents. So we intend that any new disclosure obligations should apply to all equities and their related instruments and should not be limited to certain sectors or companies.

Q13: Do you agree that the disclosure obligations should be limited to the stocks and related instruments of UK issuers?

3.5 A balance of views was expressed in response to this question. The largest group expressly agreed with our position that the disclosure obligation should be limited to the stocks and related instruments of UK issuers. A slightly smaller group specifically stated that they did not agree with our position. There were also many respondents who neither expressly agreed nor disagreed with our position, but who chose to provide additional comments.

3.6 Some respondents, including both those who agreed and those who disagreed with us, emphasised the importance of harmonised cross-border standards, particularly at EU-level. Many responses reflected uncertainty as to exactly what was meant by the term 'UK issuer', some saying that the obligation should apply to companies 'listed' in the UK (a few said that it should apply to any companies with their 'primary listing' in the UK), others using the phrase 'quoted' in the UK and others referring to companies 'traded' in the UK. Only two respondents expressed the view that the obligation should apply to all UK incorporated companies, with a number expressly stating that this was not the right test to apply.

3.7 Finally, a very small number of respondents said they believed that the disclosure obligation should extend to non-UK incorporated issuers whose home state for DTR purposes is the UK.

Our response: We note that CESR Consultation Paper CESR/09-551, '*CESR Proposal for a Pan-European Short Selling Disclosure Regime*' (the 'CESR CP') published on 8 July, proposes that a pan-European disclosure regime should apply to 'EEA issuers and those issuers whose shares are solely or primarily admitted to trading on EEA markets.' In light of the comments received, the proposals in the CESR CP, and our desire to achieve as much cross-border consistency as possible, we propose adjusting slightly the proposals regarding scope set out in DP09/1. In particular, given the CESR proposals, we believe that the requirement of incorporation in the UK is not necessary. Subject to the outcome of the CESR consultation process, we now believe that a permanent short selling disclosure regime should apply to issuers admitted to trading on regulated or prescribed markets in the UK for whom the UK is the most relevant market in terms of liquidity in accordance with Article 23(5) of MiFID.

Q14: Do you agree that the costs of introducing a regime based on disclosure of aggregate short positions would outweigh the benefits?

3.8 Slightly more of the respondents who answered this question agreed than disagreed with our stated position that the costs of aggregated disclosure outweigh the benefits. A small number were unsure. Of those who supported our stance, some believed that the costs of aggregation were unacceptably high. A significant number of those who disagreed with us advocated the informational benefits of aggregation but, of those, many were also fundamentally opposed to public disclosure of individual positions. One respondent challenged our calculation of the implementation costs of aggregation. Interestingly, another, who expressed themselves as not agreeing with us, believed that there should be both aggregated and individual disclosure.

Our response: We are aware that this was one of the more contentious issues in DP09/1 and note that, while most respondents did agree with our position, a significant number did not.

We acknowledge that publishing aggregated short-interest positions can provide additional information to the market and we recognise that this disclosure method has been adopted in several overseas jurisdictions. However, we would note that many of the respondents who advocated aggregation did so more on the grounds that they were opposed to public disclosure of individual positions than were attracted by the inherent merits of aggregation.

We do not believe that, in the UK context, the informational benefits are justified by the very significant additional costs involved in a general requirement for collecting and disclosing aggregated short selling data.

Q15: Do you agree that benefits of public disclosure of significant short positions outweigh the costs?

3.9 Most respondents agreed with our analysis that the benefits of public disclosure of significant short positions outweigh the costs. A smaller, but significant, group actively disagreed with us and a few said they were unpersuaded. Of those that supported us, some believed that private disclosure to the regulator was not enough

on its own to restore public confidence and others thought that short interest disclosure requirements should be brought in line with section 793 of the Companies Act 1986. One respondent believed that public disclosure should be at 0.25% rather than the 0.5% level proposed by the FSA; another expressed support for the principle of public disclosure as long as the level was not set 'too low'. A further respondent, while supporting us, believed that the costs had not been adequately quantified. There was also one respondent who called for cross-border harmonisation in this context.

3.10 Those who did not agree with us all raised similar concerns. Namely, the risk of 'herding' behaviour when the identities of big-name short sellers are revealed, forced disclosure of companies' intellectual property (i.e. the information they have garnered that led them to take the position), the risk of short 'squeezes' by competitors, compliance costs and, as a result of all of these factors, deterring short selling and damaging market quality.

Our response: We recognise that this is another of the issues that attracted a significant amount of opposition from respondents although, again, more came out in support of the FSA's position than opposed it. We understand concerns raised about the possibility of short 'squeezes' and the risk of herding behaviour but we have not seen any evidence of these phenomena occurring while the temporary short selling disclosure regime has been in operation. We acknowledge that there are imperfections to the information provided to the market through a public disclosure model, but believe that imperfections apply equally to the alternative that has been put forward – namely the regulator publishing aggregated data that has been provided on a non-public basis.

Overall, we still believe that, of the various transparency options, public disclosure of significant individual short positions gives the best outcome from a cost-benefit perspective. In addition to the informational benefits it provides to the market, we believe that, as we stated in DP09/1, this option will provide the means of helping to constrain aggressive short selling which may involve the threat of abuse or disorderly markets while not putting a halt to short selling. We think it is justified that, when short positions reach certain, relatively high levels, short sellers should be required to consider whether they wish to be identified to the market before they choose to continue with their strategy.

While we recognise that this may have some effect on levels of short selling, we do not expect it would do so to any degree that will reduce market quality. Our analysis of stock-lending data for the stocks covered by the Measures before, during and after the operation of the Ban suggests that short selling has resumed and that current levels are in line with what would be expected given underlying market trends.

We would also point out that public disclosure of individual positions is a cornerstone of the proposals in the CESR CP and consider it vitally important that, on such a fundamental issue, there is consistency of approach between the UK and its EEA partners.

Q16: Do you agree that an individual significant short position disclosure regime should be on a net basis?

3.11 Most of the respondents who addressed this question agreed with our proposal that only the net short position should be disclosed, with only a very small number believing that only gross short positions be disclosed. Several respondents mentioned that short positions will often be hedged by related long positions (or vice versa) and that requiring disclosure of gross positions would be both costly and misleading because of the large number of disclosures that would arise.

3.12 A group of respondents took the opportunity to state that the key issue in calculating a net short position was the organisational level (i.e. group versus legal entity and fund versus fund manager) at which the netting calculation took place. Interestingly, some respondents said that both net and gross short positions should be disclosed; explaining that this would achieve the transparency necessary to determine whether short positions were somehow being off-set inappropriately or even abusively. One respondent stated that the nature of the disclosure (i.e. whether it should be a net or a gross position) would depend on the nature of the regulatory issue at stake, with net positions being of most relevance to market integrity issues and gross positions being more relevant to understanding control of an issuer.

Our response: We note the strong support from respondents for our proposal that an individual short position disclosure regime should be on net basis. While we recognise that there are some arguments for requiring disclosure of both gross and net positions, depending on the precise nature of the regulatory interest at stake, we do not believe that the benefits are sufficient to justify the likely additional costs of compliance.

In light of the support from respondents, and for the reasons set out in DP09/1, we continue to think that using a net basis only is the right approach for disclosing a short position.

Q17: Do you agree that 0.50% would be an appropriate threshold for triggering disclosures under a net short position regime? If not, what alternative would you propose and what are your reasons for this figure?

3.13 This topic attracted a range of views from respondents and there was not a majority in favour of any specific disclosure level. The largest single group of respondents supported the FSA's proposal that 0.5% would be an appropriate threshold for triggering public disclosure under a net short position regime. However, a significant group thought it was too low and a smaller number argued to the contrary that it was too high.

3.14 A number of the respondents who believed that the threshold should be lower than 0.5% held this view because they wanted a single threshold to operate (at 0.25%), irrespective of whether or not the issuer was undertaking a rights issue. This would avoid the compliance risks of failing to identify that a company was in a rights issue. Many respondents stated that the most important issue for them regarding the precise level of disclosure thresholds was to have an agreed international standard. A significant number wanted the short disclosure regime to mirror the long disclosure regime, but some of these called for long position disclosure obligations to be triggered at 0.25% which is, of course, a far lower level than at present. Other respondents expressed the view that, whatever threshold was chosen ultimately, the

issue of threshold levels should be kept under review until the operation of the regime could be assessed.

Our response: We are conscious of the difficulties of determining precisely the correct threshold for public disclosure of short positions. These difficulties are reflected in the divergence of opinions amongst respondents. However, we continue to think that a single level should apply to all stocks, irrespective of the sector, size or any other feature of the issuer, subject to any final decision on whether there should be a separate level for rights issue stocks.

Additionally, in DP09/1 we noted the importance of achieving as wide as possible an international consensus. The CESR CP proposes that a uniform disclosure threshold of 0.5% should apply, other than in relation to companies in rights issues. Accordingly, we continue to think that 0.5% is the appropriate level at which net short positions in all stocks should be disclosed publicly, but we will obviously take account of the outcome of the CESR consultation before taking a final view on this issue. In particular, we will keep open the possibility of requiring 'private' disclosure to the FSA at a lower threshold, as currently proposed in the CESR CP. We also agree with the view that, whatever thresholds are chosen, there should be a review of their suitability after sufficient experience has been gained in their operation.

Q18: Do you agree that a banded approach to disclosure should apply in conjunction with a minimum threshold? If so, do you agree that such a banded approach should be based on bands of 0.10% of a company's issued share capital?

3.15 All but one of the respondents who answered this question agreed with our proposal that, if there were a minimum threshold for disclosure, it should operate in conjunction with a banded approach. Of those, nearly half agreed with our suggested bandwidth of 0.1%, but a similar number felt that a change of position of 0.1% for each disclosure trigger was too low because it would be operationally burdensome and/or would generate disclosures of questionable value.

3.16 One respondent suggested that, while 0.1% increments seemed appropriate, consideration should be given to setting the first threshold for ongoing disclosure in respect of a companies undertaking rights issues at 0.3%, so as to match up with the general reporting regime at levels at and above 0.5%. Another believed that the precise level for the bands needed more detailed analysis and consideration and one more stated that the precise level should be kept under review pending assessment of the operation of the regime. A few respondents stressed the importance of having an internationally agreed standard in this area.

Our response: For the reasons set out in DP09/1, we continue to believe that a banded approach should operate in conjunction with a minimum threshold. As regards the size of any bands, we note the various comments from respondents – in particular those stating that 0.1% is too low to reflect a meaningful change in position and is operationally burdensome. However, we also believe that, from a compliance perspective, it is particularly important to have cross-border consistency when it comes to the disclosure obligations arising from a change of position.

The CESR CP has also proposed 0.1% incremental bands for disclosure. We therefore intend to maintain our position that this is an appropriate band-width for a UK disclosure regime. However, we note with interest the suggestion that, if a separate level for public disclosure in respect of rights issue stocks is set, the first ongoing disclosure should be at 0.3% in order to bring subsequent disclosures in line with the general regime. We will keep that particular suggestion under consideration pending the outcome of the CESR consultation, which closed on 30 September 2009.

Q19: If long-term disclosure obligations are introduced, do you agree that market makers should be exempt from those obligations when they are acting in the capacity of a market maker? If so do you have any views on the definition of market maker that should apply for the purposes of such an exemption? Do you also agree that this should be an absolute exemption?

3.17 Respondents strongly supported market makers being exempt from disclosure requirements and the proposal that this should be an absolute exemption. Some said there should be no exemptions from a disclosure regime. And a number of respondents provided comments on how market makers should be defined for these purposes, a couple advocating a wider definition and others stressing the importance of clarity so as to minimise the potential for abuse by those falsely claiming that they were acting in a market making capacity. A few respondents indicated that they considered international agreed definitions to be essential.

Our response: As we stated in DP09/1, the provision of liquidity by market makers is vital to the efficient and effective operation of our markets. For this reason we advocated an absolute exemption from disclosure obligations for market makers.

There was strong support from respondents for this position so, for the reasons set out in DP09/1, we continue to believe that market makers should be exempt from disclosure obligations when they are acting in the capacity of market maker. We agree with those respondents who highlighted the importance of defining 'market maker' for these purposes and of ensuring that it is sufficiently broad as to capture genuine liquidity providers but not so wide as to be open to abuse.

Our current view is that the definition we promulgated in our Frequently Asked Questions (FAQs)[6] on the short selling disclosure regime is fit for purpose. However, in the interest of international consistency, we will keep this issue under review pending the outcome of the CESR consultation.

Q20: Do you agree that maintaining the current disclosure obligation of 0.25% of a company's issued share capital for rights issue situations is appropriate?

3.18 A relatively low proportion of respondents chose to answer this question. More respondents disagreed than agreed with our proposal that the disclosure obligation in rights issue situations should remain at 0.25% while there was a general disclosure obligation at 0.5%.

6 www.fsa.gov.uk/pubs/other/Short selling_FAQs_V2.pdf

3.19 The vast majority of those that did not agree with us advocated a single threshold for disclosure and no separate treatment for short positions held in companies engaged in rights issues. The principal reason for respondents taking this stance was a concern about the difficulty and cost of compliance with a differentiated regime. Many of these respondents indicated that a single threshold regime should operate at or above 0.5%, although one did argue that it should be set at 0.25%. Another respondent expressed the concern that investors would close out short positions as soon as rights issues were announced.

3.20 One respondent asked us to make it clear whether a final disclosure is required in rights issues situations when a position passes down through the initial disclosure threshold. Another felt that a differentiated regime as proposed by the FSA might be appropriate in 'times of distress', but not in normal market conditions. Finally, one respondent stated that consensus and uniformity on this issue within Europe was crucial.

Our response: We continue to believe that companies are particularly vulnerable when seeking to raise capital through rights issues and that care should be taken to ensure that they benefit fully from the protection afforded by transparency for short selling. Nevertheless, we have some sympathy for the concerns expressed on this issue and recognise that having a separate threshold for disclosure of short positions held in companies engaged in rights issues imposes additional compliance challenges, particularly those arising from ensuring that all companies that are raising capital are properly identified.

We note that if we were to implement the two-tier regime requiring 'private' disclosure to the regulator at a lower threshold (0.1%), in line with the proposals in the CESR CP, we would have access to information about rights issues companies at an early stage. This would help us to act quickly if we were particularly concerned about aggressive short selling of stocks of a company engaged in a rights issue. Accordingly, although we are not at this stage departing from the proposal for a 0.25% threshold for rights issue short position disclosure – not least because it remains part of the CESR proposals – we do believe there is scope for re-considering whether, in all the circumstances, a separate lower threshold for rights issue companies is necessary .

Depending on the outcome of the CESR discussions, we may consider exploring whether there are alternative ways of providing additional protection here, e.g. by making use of any position data disclosed privately to regulators.

Q21: Do you agree that the ongoing disclosure obligations should be the same as the general regime?

3.21 There was very strong support for our proposal that the ongoing disclosure obligations should be the same for rights issue situations as for the general regime, with only two of the respondents to this question disagreeing. Many of the respondents reiterated the importance to them of standardisation between the rights issue regime and the general disclosure regime. It should be noted that a few respondents, while advocating standardisation, did state that they believed that 0.1% bands (for both regimes) were too wide.

Our response: For the reasons set out in DP09/1, and in light of the very strong support from respondents, we will keep ongoing disclosure obligations the same for rights issue situations as for the general regime – namely, disclosure should take place as subsequent bands of 0.1% above the initial disclosure are reached.

We note also that the CESR CP proposes the same ongoing obligations. As stated earlier, we will also keep under consideration the suggestion that the first ongoing disclosure for companies in rights issues should be set at 0.3% in order to bring subsequent disclosures in line with a general regime pending the outcome of the CESR consultation.

Q22: Do you consider that any further measures are necessary in respect of CDS?

3.22 The vast majority of respondents either stated that no further measures were necessary in respect of CDS or had nothing to say in response to this question. Of the remainder, some stated that our proposed disclosure regime should capture all instruments that can create synthetic short positions; a few going on to say that this would include CDS. Other respondents argued for greater transparency in the CDS market, but did not go as far as saying that our proposed disclosure regime should apply to it. Another two respondents indicated that they believed that CDS trading should take place on-exchange and two called for a centralised clearing mechanism.

Our response: For the reasons set out in DP09/1, we do not consider that any further measures are necessary for CDS. The issue of the trading and clearing of CDS falls outside the scope of this consultation.

Annex 1

List of non-confidential respondents

Alternative Investment Managers Association

Association of British Insurers

Association of Corporate Treasurers

Association of Investment Companies

AQR Capital Management

British Bankers' Association

British Property Federation

Cazenove Capital

City of London Law Society

CFA Society UK

Chris Erwin

Coalition of Private Investment Companies

Confederation of British Industry

David Hind

D.E. Shaw & Co (UK) Ltd.

E.R. Chalker

Experian

Faisal Danka

Hedge Fund Standards Board

Hermes Equity Ownership Services (also on behalf of Irish National Pension Reserve Fund, PNO Media, BBC Pension Fund, Canadian Public Sector Pension Investment Board)

Hutchin Hill

Ian R. Peacock

Ignis Asset Management

International Corporate Governance Network

Investment Adviser Association

Investment Management Association

Investor Relations Society

JLT Benefit Solutions

Legal and General Investment Management, Legal & General Group Plc.

London Investment Banking Association (LIBA), International Securities Lending Association (ISLA), Securities Industry and Financial Markets Association (SIFMA), International Swaps and Derivatives Association (ISDA)

London Stock Exchange

Makinson Cowell

Managed Funds Association

Meditor Capital Management

Mergers & Acquisitions Monitor Ltd.

NAPF

Prudential & M&G

Philip Milton & Co.

Renaissance Technologies LLC

Richard Davies: Investor Relations

Robert Gray

Russell Investments

Shire

Simmons & Simmons

Society of Lloyd's

UK Shareholders' Association

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