Public comment on FSA's Discussion Paper on Short Selling (DP09/1) by the Hedge Fund Standards Board (HFSB)

Introduction

Short selling plays an important role in global financial markets and brings many benefits to the global economies, including investor protection against market volatility, increased liquidity for all market participants, more efficient price discovery, dampening of price bubbles and prevention of other market inefficiencies, and ultimately more efficient capital allocation.

The ability to sell stocks short makes investing far more attractive at times of stress because it encourages investors to stay in the market even when prices are declining. By hedging their positions through short sales, investors can continue to hold other stocks with the aim of achieving absolute returns. Without the option to short sell, investors are much more likely to withdraw from a declining market, accentuating the market contraction during major crises like the present one.

The recent short selling ban has brought this investment management and hedging instrument to the forefront of the public and regulatory debate. The HFSB is pleased to comment on the FSA Discussion Paper on Short Selling.

HFSB Responses to specific questions

Regulatory options: potential constraints on short selling (p.15 -22)

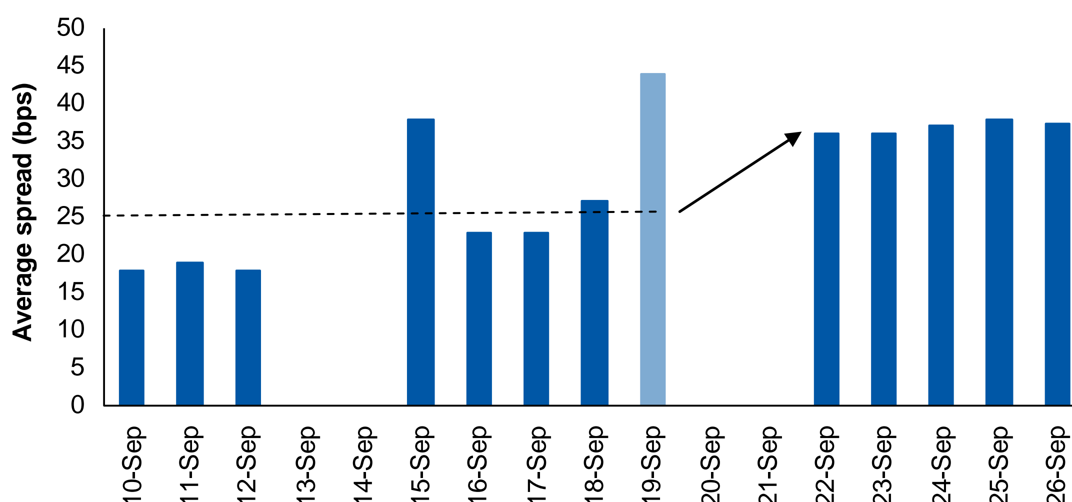
Q1: What are your views on the cost and benefits of a blanket short selling ban? Where possible, please quantify.

HFSB agrees with FSA that the benefits of short selling outweigh any type of presumable negative impacts.[1] It is difficult to assess the benefits in economic terms (eg estimating the incremental economic growth due to better capital allocation in the economy and lower transaction cost), however, it is easy to detect the negative effect of a short selling ban (eg in terms of increased transaction cost, etc). Figure 1 contains an illustration of the rise in transaction cost observable in the market after the short selling ban. [2]

[1] See HFSB input to CESR short selling consultation (January 2009), available at http://www.cesr-eu.org/popup_responses.php?id=4478, providing an overview on the role of short selling in markets.

[2] Source: Credit Suisse Portfolio Strategy / AES Analysis, 09/2008, based on US market data.

Figure 2: Trading cost



Source: Credit Suisse Portfolio Strategy/ AES® analysis

Beyond market efficiency and transaction cost, HFSB believes that a short selling ban implicitly signals to markets that the practice of short selling results in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. However, in the context of the recent crisis, we believe that on the contrary, the price discovery process was functioning and the ban may actually have distorted it.

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

We agree that there should not be a blanket short selling ban.

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

The HFSB does not think that further measures are required in the context of naked short selling. As illustrated in the HFSB waterfall approach (as described later on), a ban on naked short selling could be employed as one potential measure in times of disorderly markets, but only if short selling (or excessive delivery failures) are the cause of disorderly markets.

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

No, this is not justified given the beneficial market function that short selling has. In times of disorderly markets (again, only if caused by short selling), FSA could still consider banning (naked) shorting of financial sector stocks. However, it is important that the assessment actually identifies short selling as the cause of disorderly markets.

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?

HFSB agrees that short selling is an important risk management technique in relation to rights issues, therefore, a short selling ban might indeed be counterproductive in the context of rights issues. HFSB acknowledges the potential for abuse in the context of rights issuance because companies are

particularly vulnerable to harmful rumours. However, since it is a matter of assessing market abuse, disclosures, if any, should only be made to the regulator (and not publicly).

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)?

HFSB agrees, since short selling serves as a risk management techniques used by underwriters. As highlighted by FSA, it is important to have adequate mechanisms in place to manage and mitigate conflicts of interests arising in the context of underwriting, and HFSB has no evidence that existing measures are insufficient.

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?

HFSB agrees that FSA should maintain all options to combat market abuse/or to maintain orderly markets. However, it is important to complement this with a robust analytical framework to ensure that the "right" type of measure is employed (with the right "dosage") to address the actual cause of any potential issue (and not just a symptom). The reason why HFSB is stressing this is that regulators have indeed a broad and fine tuned arsenal of tools to fight disorderly markets, but these need to be employed with utmost care, to avoid that the regulator ultimately becomes the source or an amplifier of market disruption and disorder, due to presumably well meant intervention, which ultimately prevents the price formation process from happening and undermines confidence in markets.

HFSB would like to caution regulators' expectations with respect to the effectiveness of market interventions with the aim of restricting short selling. In the context of the recent short selling restrictions, statements by regulators have confirmed that short selling was not seen as the root cause of the crisis, but that falling bank stocks were instead the consequence of the broader problems in the banking sector and a general loss of confidence which ultimately could only be resolved through massive government intervention. With or without short selling, the public realised that banks were extremely vulnerable, due to their exposure to risky assets far beyond what their reduced levels of equity would support. Since this lack of confidence very quickly led to bank runs and given that several financial institutions filed for bankruptcy, investors shied away from bank stocks for reasons which have no relation to short selling.

HFSB acknowledges that when regulators and politicians are coping with an emergency brought on by fears of a meltdown of the banking system (ie. run on the banks caused by plummeting bank stocks), extreme measures may be warranted. In such instances, however, it is important that regulators and politicians assess the adequacy of specific measures to resolve a given problem. ("Does the measure help to restore order to the markets?", "Does the measure prevent bank stocks from falling further?", Does the measure clearly facilitate vital capital raising activities?" or ultimately "Does the measure reduce the probability of a run on the bank?").

Indeed, regulatory intervention interfering with the market and price formation process can have a more devastating impact, since it can give rise to concern by investors about the efficiency of the price formation process, and thereby trigger further sell offs of those who would otherwise hold on to their assets. Also, regulatory interference (eg in relation to short selling) can also implicitly tell the

markets that the practice of short selling results in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. However, in the context of the recent crisis, we believe that, on the contrary, the price discovery process did function, and that the short selling ban may have distorted the price discovery process, and that the ban has ultimately undermined confidence in the markets.

Therefore, it is of utmost importance that the regulatory toolkit to be developed in relation to short selling is anchored in a) a rigorous process for identifying and classifying disorderly markets, and b) a carefully calibrated spectrum of tools/mitigants that can be employed to counter disorderly markets (as part of this, restrictions on short selling might be only one of the available tools. We believe that in many instances short selling will not be the cause of disorderly markets). Appendix 1 contains an illustrative "waterfall approach", which could be drawn upon after careful assessment of the root cause for disorderly markets (to avoid that regulators ultimately become the source or an amplifier of market disruption and disorder).

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

HFSB does not see the need for additional regimes and agrees with the FSA that existing arrangements are sufficient.

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

HFSB acknowledges the complexities in relation to introducing tick rules and agrees with the FSA not to introduce this measure on a permanent basis.

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.

No.

Regulatory options: enhanced transparency (p. 23-25)

HFSB agrees with FSA's approach to seek international consensus in relation to any short selling disclosure regime (ie involving IOSCO and CESR) in order to avoid the complexities that arise if market participants have to cope with multiple regimes across jurisdictions.

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

Summary of HFSB position:

The transparency requirements need to be assessed in light of three overarching objectives: financial stability, information in relation to control, and market integrity. Based on this assessment (as set out below), HFSB has a differentiated view on transparency around short selling:

- Disclosures in relation to systemic concerns and market abuse should be to regulators only. In both instances, disclosures should only be required in times of distress. HFSB has no evidence of systemic threats or particular concern in relation to abusive behaviour such as "short and distort".

- Public disclosures should be symmetric, mirroring the disclosures required in the context of long positions (eg 3%, including equity and instruments).

HFSB first comments on some of the specific points highlighted by FSA, and then describes a framework approach to assess disclosure requirements in relation to short selling.

Specific comments:

FSA mentions among the benefits of enhanced transparency that short selling conveys a signal to markets that a firm is overvalued (5.7). Along those lines, one could equally argue that on every short sale, there is a buyer, thereby signalling to markets that the stock is undervalued. Therefore, the "net signal" is actually not indicative at all of whether the stock is over or undervalued. In addition, short selling is used in hedge transactions, where only the relative directional movement of a shorted stock matters (in relation to the respective long position), irrespective of whether the market rises or falls.

Therefore, HFSB would argue that <u>all information is reflected in today's market price, irrespective of whether short selling has occurred or not</u>. The aggregate impact of short selling might have reduced that price, but thereby this information is included in today's market price.

Portraying that short selling activity is a signal to other investors that a stock is overvalued is only true under the assumption that the parties short selling the stock have better information than those buying the stock. If some investors assume that mostly hedge fund managers engage in short selling and that hedge fund managers have better information, then they might give more weight to the fact that short selling occurs (rather than just assuming that today's price is the best estimate of future value).

The problem arises if regulators now argue that short selling can convey a signal, because they implicitly tell market participants that short sellers indeed have better information, and thereby encourage herding behaviour based on short selling disclosures. HFSB believes that it would be an arbitrary decision to enhance disclosure on the grounds of "additional valuable information" and that this might lead to market distortions/less efficient price discovery.

The second benefit that FSA highlights relates to detection of market abuse in the context of short selling (5.8). HFSB agrees that regulators need to have tools to assess and monitor issues in relation to this, but it is important to highlight that no public disclosure requirement arises from this. It is only the regulator who might have additional information needs (or access to information, if needed).

HFSB also agrees that any potential negative impacts need to be assessed, including loss in market efficiency (a. discouraging information acquisition, b. encouraging herding (as per above)) and cost of additional disclosures.

Framework approach

HFSB would like to propose a framework to assess the transparency needs in relation to short selling, thereby enabling the design of a meaningful reporting and transparency regime. The objective of the framework is to provide answers to the following questions:

- What is the issue we are seeking to address? (systemic issues, control issues, market integrity)
- What existing law and regulation is already in place to address the issue?
- Are additional measures required (in particular disclosure/transparency)?
- To whom is this information relevant?
- What information is needed? (ie nature, frequency, trigger levels, reporting by whom)
- What are potential regulatory measures / mitigants in relation to the issue (eg based on the information/disclosure)?
- And what are potential concerns in relation to these measures / mitigants?

This framework makes it possible to derive the high level features of a short selling disclosure regime which could form the basis for further discussion at international level (IOSCO, CESR). Once these overarching features/principles are agreed, it will also be easier, in a second step, to determine some of the more detailed features.

The starting point of the analysis are the three major motivations behind additional disclosures of short positions, 1. financial stability, 2. Issues in relation to control (firms might want to know who short sells them) and 3. market integrity. The following table provides the required assessment along the questions set out above:

Assessment of short selling disclosure regimes

What is the issue?	What are we seeking to achieve?	What existing law and regulation is in already in place to address the issue?	Are additional measures required (in particular disclosure/transparency)?	To whom is this infor-mation relevant?	What information is needed? (ie nature, and frequency, trigger levels, reporting by whom)	What are potential regulatory measures / mitigants in relation to the issue?	And what are potential concerns in relation to these measures?
Financial Stability	Enabling regulators to spot and counteract risk of disorderly markets and financial instability *[HFSB sees no evidence for disorderly markets caused by short selling]*		It does not appear that there is a permanent threat to disorderly markets in relation to short selling at all. Indeed, the crisis in fall 2008 has not been caused by short selling. Therefore, it is difficult to build a case for a permanent reporting/transparency regime in relation to short positions. However, regulators should be in a position to collect relevant data during times of distress. The focus should then lie on systemically relevant sectors (such as banking, insurance) and aggregate data.	Only regulators	Nature: Aggregate short position (eg to assess in relation to trading volume). This can be estimated from available stock lending information (which can serve as a proxy (upper bound)). Where needed (due to lack of stock lending data), this could be derived by requiring disclosure of short positions by market participants (eg beyond a certain threshold). Frequency: Only in times of distress (although stock lending data from private data aggregators is permanently available).	This is a very sensitive issue, since regulatory intervention can by itself hurt market confidence and thereby actually enhance distress. HFSB has set out a "waterfall approach" (see appendix) that could be drawn upon, but only after careful assessment of the causes of distress (ie is short selling really to blame, or just a symptom of something else?)	- Cost to collect data (when collected from individual market participants, however, since this might only be seldom temporary measures, the cost might indeed be negligible) - Leakage risk of individual positions (in case of data collection from individual market participants)

Control issues	-Allowing transparency for control purposes - ("Firms should be able to know who short sells them (beyond a certain threshold")	Disclosure and Transparency Rules (only for long positions)	Mirroring the long disclosure requirements on the short side. An investor might have a gross long position exceeding the 3% threshold, but also has a short position exceeding 3%, thereby ultimately not being economically exposed at all (net position of 0%), but can exercise control. This might be relevant information to the underlying company.	All market partici-pants	*Nature:* Combined (gross) short position of shares and instruments (such as CFD) of individual market participants. *Threshold:* Symmetric to longs, eg 3%, and for each % point thereafter *Frequency:* Whenever a threshold is surpassed	No further regulatory measures/mitigants required (this is just a matter of disclosure).	-Excessive transparency could alter the risk-reward ratio for short sellers (reducing the price correction benefit) - Information message from a short sale might be ambiguous
Market integrity	Preventing market abuse in relation to short selling (HFSB does not have evidence that market abuse issues have significantly higher relevance on the short (ie spreading rumours)	-Existing market abuse law	For market abuse detection purposes, investigative powers for regulators including information access to detect abuse in relation to both long and short positions.	Regulators	*Net short position of individual market participants.* *Threshold: Unclear if a lower threshold is needed to report to regulators to assess market abuse issues.* *Potential additional needs: Information on excessive settlement failures*	-Enforcement of existing market abuse law and regulation -Investigation of settlement failures to detect abusive behaviour	-Excessive disclosure could alter the risk-reward ratio for short sellers (reducing the price correction benefit) - Information message from a short sale might be ambiguous

There is one important distinction to highlight regarding the disclosure regimes illustrated above: While for financial stability and market integrity purposes, the information is only relevant to regulators, it is the individual investor level public disclosure that is relevant in the "control" context to all market participants (and regulators). In the latter context, the question arises what should be the adequate disclosure thresholds for individual short positions. The HFSB believes that a symmetric approach is appropriate, mirroring the disclosures required in the context of long positions for the following reasons:

- The market impact of long and short positions is similar;
- Underpriced stocks are equally damaging as overpriced stocks from a market efficiency perspective.
- The risk of market manipulation is equally damaging whether it takes place in the form of long or short positions. (see below)

Currently, the long position disclosure regimes vary by country: In the UK, the Disclosure and Transparency Rules require disclosure of the combined long position of shares and CFDs if the 3% threshold is exceeded and for each percentage point thereafter (UK issuers).

HFSB does not see clear evidence that for market integrity purposes, a lower disclosure threshold is required.

Beyond establishing a symmetric approach for short disclosures, HFSB would welcome further European/global harmonisation of disclosure mechanisms.

Finally, for market integrity purposes, as mentioned above, market manipulation is equally damaging whether it takes place in the form of long or short positions. The question arises if market abuse is now a particular issue in the context of shorting, which would justify the need for insights by regulators (eg a permanent lower disclosure threshold). Here, HFSB is not convinced that a permanent reporting regime (to regulators) with lower disclosure thresholds is required. Potentially, powers to investigate specific cases (and to request the relevant information) are sufficient, also from a cost benefit perspective.

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?

In general, HFSB agrees that disclosures should include equities and related instruments. HFSB also agrees that financial sector stocks are particularly vulnerable. The following table provides a brief overview on the scope of disclosure in relation to the issues addressed in the framework above:

Issue	Type of disclosure regime	Scope of Disclosure	Comment
Systemic concerns	Ad hoc/only in times of distress	Aggregate short / as dictated by events/concerns	The banking and insurance sector are generally considered "systemic" in relation to the financial system.
Control purposes	Permanent (beyond threshold)	Gross short (all equities and instruments (eg CFDs))	Symmetric disclosure (see framework above)

Market integrity	Ad hoc/on demand	Net short (all equities and instruments (eg CFDs))	Ability to request this information is sufficient.

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

HFSB agrees. Respective overseas regulators should take action in respect to non-UK issuers.

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

HFSB agrees that the incremental precision that could be obtained from a regime to calculate aggregate shorts is not justified from a cost benefit perspective, in particular given the available data on stock lending (which can serve as a proxy) from private data providers. The deciding factor here is that regulators are satisfied with the aggregate information they have available on stock lending, since HFSB believes that there is no case for building a public disclosure regime.

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

HFSB agrees that there should be public disclosure of significant short positions, and as highlighted above, we believe that a symmetric approach is appropriate, mirroring the disclosures required in the context of long positions (eg 3% threshold).

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

For market integrity assessments, the net position is relevant (to regulators).

For purposes in relation to control, it is the gross 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?

HFSB agrees with FSA that the long disclosure regime aims at transparency with respect to control issues. For symmetry purposes as described above, the gross short should be equally disclosed (beyond 3%).

However, if the focus here lies on risks to market integrity, it is important to highlight that regulators are the relevant addressee of the any type of information. HFSB agrees that regulators need to have information to assess potential risk of market abuse. However, HFSB does not see evidence that there is a higher risk for market abuse in relation to short positions than long positions, since ultimately, the market impact of both positions is similar.

Now, if FSA indeed seeks to implement a short disclosure regime (eg with a 0.5% threshold) to regulators (!), it will have to build a strong case around the higher risks of market abuse in relation to shorts (vs. longs), which HFSB believes is difficult to establish.

If FSA indeed seeks to implement a public disclosure regime (and leaving aside HFSB's reservations about public disclosure other than on a symmetric basis in relation to control), HFSB would argue to set the threshold higher, such as at 1% or more, and to carefully assess the detrimental impact of these disclosures on market efficiency (eg herding based on ambiguous information, discouraging information acquisition).

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?

Leaving aside concerns mentioned above, HFSB agrees that there should be a banded approach. The width of the bands is a function of the accuracy needed by regulators to assess potential market abuse issues. HFSB believes that wider bands, eg 0.25% or larger could be sufficient, given that it is not so much the exact level (beyond the threshold) that might matter regulators, but the information on who has engaged in short selling.

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?

HFSB agrees that there should be exemptions.

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?

HFSB agrees that firms are more vulnerable during rights issuance periods. Here again, the concern is market abuse, where HFSB would argue that relevant addressee of disclosures should be the regulator (to detect market abuse). The relevance of this issue might vary over time: In times of distress, lower thresholds might be warranted (in particular, for systemically relevant institutions such as banks), while during normal times, higher thresholds might be sufficient.

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

HFSB agrees that there should be a banded approach.

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

HFSB does not see need for further measures.

Appendix 1: Illustrative overview of waterfall approach to counteract disorderly markets

	Potential measures
Stage 1	• Short selling restrictions during rights issuance periods of banks (eg lowered disclosure threshold)
Stage 2	• Banning of uncovered/naked shorting
Stage 3	• Enhanced disclosures (aggregate disclosure to regulators)
Stage 4	• Uptick rule
Stage 5	• Banning of covered shorting
Stage 6	• Suspending stocks from trading /closing a market