The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

Katherine Salih
Retail Policy & Conduct Risk Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

dp09_01@fsa.gov.uk

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Dear Katherine

FSA Discussion Paper DP 09/1 ("Short selling")

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Regulatory Committee. Members of the CLLS Regulatory Committee (the Committee) advise a wide range of firms in the financial markets including banks, brokers, investment advisers, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

We are writing to respond to a number of the issues raised in Discussion Paper DP09/1. We have in the main focused on the issues which have legal as well as market implications, and accordingly have not sought to respond to each individual question in the Discussion Paper.

First and foremost, it appears to us of critical importance, both for the markets generally, and for the UK's competitive position, that the FSA should maintain its close involvement in, and coordination with, regulatory initiatives relating to short selling, both at European level and internationally. We are therefore supportive of the fact that the FSA has published a Discussion Paper at this stage with a view to finalising the UK regulatory approach once a greater degree of international consensus has been achieved on the regulation of short selling.

As the Discussion Paper acknowledges, the implementation of temporary measures at short notice put considerable strain on systems and resources, and most particularly on the many market participants operating across multiple jurisdictions, who were forced during the rapidly evolving events of last September to negotiate a panoply of different regulatory measures and regimes in those jurisdictions, in order to achieve compliance across their businesses. From a legal point of view, the initial iterations of the temporary measures in various jurisdictions lacked clarity, and there was considerable uncertainty about the scope and effect of the regimes, which was gradually dealt with through guidance in the form of evolving FAQs, though many regulators were slower in formulating this guidance than the FSA. Michel Prada expressed his disappointment at the lack of a coordinated approach with respect to short selling measures at the launch of the International Centre for Financial Regulation. We also note that jurisdictional inconsistencies have made it extremely difficult for market participants to manage disclosure through automated systems; most are currently managing disclosure through a combination of automated and manual systems.

We believe that a consistent set of short selling measures across European and other significant global markets is a priority, and that achieving this should be a key objective of the FSA. We therefore welcome and support the FSA's endorsement of the desirability of seeking as wide as possible an international consensus on the short selling regime and at a minimum, a more harmonised approach within the EEA. In view of the work being carried out by both IOSCO and CESR, in which the FSA has been closely involved, we would strongly encourage the FSA to defer any final decisions on the issues under discussion pending the outcome of that work, in order to ensure a fully coordinated European regulatory response, and to minimise disruption and cost to market participants.

The temporary regime is due to expire at the end of June. It would be helpful if the FSA was able to provide as early an indication as possible as to what action it intends to take at that point, particularly if any changes are to be made to the current arrangements, in order to enable firms' time to make appropriate adjustments. We believe it would be preferable to lift or prolong the existing temporary measures for a further period on 30 June 2009, to maximise the prospects of a fully coordinated European response and enable further debate and consideration of any detailed proposals.

1 Prohibition on short selling – questions 1 to 6

1.1 We appreciate that the emergency measures put in place by regulators in September 2008 were a response to extreme circumstances prevalent at that time, aimed specifically at guarding against further instability in the financial sector. We also note that the removal of the ban in January 2009 did not provoke renewed market instability.

1.2 As the Turner Review acknowledges, the available research strongly suggests that the emergency short selling restrictions in relation to financial sector stocks led to a reduction in market quality (defined as price volatility and liquidity) in the affected stocks in the period following the ban, and an increase in bid-offer spreads. We refer in particular to research by Capital Markets CRC Limited commissioned by the London Stock Exchange, and to the comments in the Turner Review. In the US context, we note comments by SEC Commissioners Troy A. Paredes and Kathleen Casey regarding the effect of the ban, and research by SunGard Astec Analytics which confirmed that the expiration of the US ban did not prompt a new wave of short sales in those stocks. For these reasons we do not support any form of blanket or sectoral ban on short selling.

1.3 So far as we are aware, there have been no significant issues with failed trades in relation to naked short selling within the EEA. We are of the view that the existing requirements with regard to delivery, and for settlement of failed trades, are fit for purpose and that there is no need for additional measures to deal with naked short selling. We also note that the FSA has in the past taken successful enforcement action under the market abuse regime in respect of short selling in circumstances where there were no appropriate plans for settlement of the resulting positions (*Evolution Beeson Gregory, 2004*).

1.4 We also believe that short selling has a legitimate role to play in rights issues, as the Discussion Paper acknowledges. We agree with the FSA that abusive short selling strategies can be effectively dealt with under the current market abuse regime, and that the FSA's powers enable it to obtain evidence and take enforcement (including criminal) action where appropriate.

1.5 Although the Discussion Paper refers to continuing concerns and to the possibility that hedge funds may have a greater propensity to mitigate their underwriting risks through short selling, we consider that no case has been made out for placing any additional constraints on underwriters of rights issues. As canvassed in paragraph 4.18 of the Discussion Paper, there are already a variety of contractual and regulatory requirements which operate to constrain the ability of underwriters to short sell shares in a company which is launching a rights issue. We agree that the costs and potential detrimental effects of such a ban far outweigh any perceived benefits.

1.6 Accordingly, we are of the view that there is no case for the imposition of a blanket ban or any form of permanent ban on short selling, whether across the board, within particular sectors, or during rights issues. As the Discussion Paper acknowledges, we believe short selling to be a legitimate investment technique in normal market conditions, which contributes to pricing efficiency and enhances liquidity.

2 Powers to intervene in cases of emergency – question 7

2.1 We are not persuaded that the FSA requires additional emergency powers to deal with abusive sort selling strategies (although we accept that the FSA would be assisted by the plea-bargaining powers it hopes to obtain in the current Parliamentary session). We consider that the FSA's powers to intervene in cases of market abuse are adequate to cover misconduct arising in connection with short selling. We note that under section 381 of the Financial Services and Markets Act 2000, the FSA has the power to apply to the court for an order restraining market abuse.

2.2 To the extent that it may be necessary to intervene to maintain or restore stability and order in the markets in times of extreme market stress or fragility, however, we do not consider the market abuse provisions to be the appropriate framework for such measures.

2.3 We strongly support the FSA in exploring what legislative changes might be necessary to provide it with long-term powers to make any emergency interventions. It is vital to ensure that any emergency powers be placed on a proper statutory footing, so that emergency measures are placed on a legally sound footing, and cannot be subject to challenge on the grounds that they are ultra vires.

2.4 As the FSA is aware, there are real concerns about the way in which the temporary measures purported through evidential provisions to alter the definition of market abuse: the FSA changed its handbook overnight to state that, in its opinion, certain behaviour which it had previously considered to be legitimate was to be considered to be market abuse (misleading impressions) not because any misleading impression was being created, but because the FSA expressed that opinion. We appreciate that in the then prevailing circumstances, this was a pragmatic means of ensuring that the measures applied to the unregulated as well as the unregulated community – we believe that the fact that the ban went unchallenged suggests that the market also appreciated that the measures aimed to stem the decline in share prices and to mitigate systemic risk in what were clearly unprecedented circumstances.

2.5 In designing any long-term emergency powers to enable regulatory intervention by the FSA in times of extreme market fragility where the FSA reasonably considers that short selling has the potential to exacerbate declines in share price to an unacceptable level, we believe that it is important that the framework should be fully transparent, and (within appropriate limits) accountable, in order to ensure market confidence, given that such interventions can have particularly severe impacts on the market.

2.6 Our committee would be very interested in further discussing the detail of any proposed emergency powers once the FSA has developed some proposals.

3 Additional constraints on short selling – questions 8 to 10

3.1 We do not propose to comment on additional constraints which are more market issues than legal matters, although we note, in relation to circuit breakers, that there are already provisions which enable trading to be halted.

3.2 However, we are aware that in some jurisdictions, consideration is being given to the imposition of constraints on stock lending and we consider that it would be helpful to comment briefly on that.

3.3 Stock lending is by no means a perfect proxy for short selling. Although borrowing stock to settle an outright sale of securities is perhaps the most common motivation, stock lending plays a much wider role in the efficient operation of markets and in the creation of liquidity. Other reasons for stock borrowing include borrowing by market makers to fill customer buy orders, borrowing by exchange specialists to maintain price stability, borrowing by stockbrokers to cover a short position after failed settlement, hedging by counterparties to contracts for differences, spread bets and swaps, and dividend capture strategies. Lending of securities is primarily motivated by the fee income received from the loan, but can also be motivated by the desire to borrow short-term money, through transactions such as repurchase agreements or cash-collateralised securities lending.

3.4 We are of the view that it would be crucial that there should be a proper analysis of the potential impact on market efficiency and liquidity of the imposition of any direct constraints in respect of stock lending before any such measures were contemplated.

4 A permanent disclosure regime on a proper statutory footing

4.1 As the FSA is aware, we are keen that a number of fundamental concerns associated with the current temporary regulation of short selling should be resolved in the permanent short selling measures. We have already indicated that we consider it inappropriate to seek to regulate short selling through the market abuse regime set out in section 118 of the Financial Services and Markets Act 2000. This applies to emergency interventions in times of market fragility (see paragraph 2.5 above), and also to any permanent disclosure regime.

4.2 Specifically, we believe it is incorrect to regulate short selling on the basis of a blanket assumption that an undisclosed net short position above a particular size is market abuse (misleading impressions). The market abuse regime was not intended or designed to operate as a regime for the disclosure of positions in securities, and we note that a number of European regulators[1] have created standalone requirements outside the market abuse provisions. In so far as legislative amendment is required to devise an alternative disclosure regime that applies to the unregulated community, it seems to us that this should be achievable within the timeframes to which the European and international measures appear to be operating.

5 The benefits of transparency around short selling – question 11

5.1 We are not aware of any published research on the impacts of the disclosure regime which compares trading before the introduction of the emergency measures and trading since the lifting of the ban. We consider that such an analysis would be of vital importance to inform the debate as to the costs of transparency. We are not convinced that there can be any useful read across from data relating to the disclosure of trades by corporate insiders or to major shareholder notifications.

5.2 We are aware that some market participants have indeed adjusted their behaviour to stay under the disclosure limits, and are likely to continue to do so whether the thresholds are increased or decreased. This will have had a potentially adverse impact on liquidity and price formation. The FSA is no doubt aware of the concerns of hedge fund managers about disclosure of what they consider to be proprietary information about their trading strategies. There are also legitimate concerns that disclosure of such positions (particularly by "star" participants) risks encouraging herding behaviours.

[1] E.g. AFM, AMF.

5.3 The costs of managing a permanent regime will also vary enormously depending on whether participants are seeking to manage different obligations in different jurisdictions, and it is therefore too early to reach a final conclusion. We consider that there is more work to be done on the cost benefit analysis, particularly since this will also be heavily dependent on the method of disclosure selected (as to which, again, international, or at least European, consensus is crucial).

6 Scope of disclosure obligations – questions 12 and 13

6.1 If a disclosure obligation is going to be introduced, then we accept that the financial sector is not the only sector which, in times of market fragility, is potentially vulnerable to declines in share price which can be exacerbated to an unacceptable level by short selling, and we see the merit of creating a level playing field for issuers. A simple and consistent application of transparency rules will also be easier for firms to manage.

6.2 We also agree that any requirement should be restricted to UK incorporated issuers. This should facilitate the drafting of appropriate provisions and will assist the enforceability of the regime by the FSA.

7 The types of disclosure option – questions 14 to 16

7.1 We are aware that the buy-side and sell-side of the market hold divergent views about which type of disclosure option is preferable, and to that extent it appears to us that it is not for this Committee to comment on the market aspects raised in the Discussion Paper.

7.2 However, it did appear to us that there was some confusion in the arguments being advanced in favour and against the various disclosure options, and that to some extent this was a reflection of the tensions between the two underlying policy aims:

7.2.1 No real case is made out for the disclosure of the identity of the short sellers, as opposed to the size of the relevant positions. It is also not clear that disclosure of short sales would have prevented, rather than exacerbated, the downward price-spirals experienced last autumn. It seems to us that if anything, herding behaviours would have been reinforced, and the liquidity issues suffered by the markets would have been aggravated.

7.2.2 We accept that a disclosure regime would help the FSA in detecting short selling which might be being used to commit market abuse, and might provide advance warning of conditions which may warrant regulatory intervention. It does not seem to us that these aims are better achieved through public disclosure rather than by disclosure to the regulator.

7.2.3 It also appears to us odd that the FSA should invoke consistency with the requirements in the Disclosure Rules and Transparency Rules in support of this argument when the FSA relies elsewhere on the fact that the regulatory purposes of the two regimes, and the risks they seek to address, are quite different.

7.2.4 We agree that any incremental systems costs to firms of having to make public rather than private disclosure are not a major factor.

7.3 Overall, we do not feel that the case for public disclosure by market participants has as yet been compellingly made out. However, we are also mindful of the fact that it will be important to ensure that the regime is as consistent as possible with comparable regimes in Europe, and that this is still a Discussion Paper.

7.4 On the assumption that some form of disclosure of short positions was to be required, then it seems to us that the FSA's stated aims would best be achieved through net position disclosure, though we would in due course welcome more detailed discussion of the detailed proposals.

8 Thresholds and bands – questions 17, 18, 20 and 21

8.1 The size of the threshold, both in relation to the general obligation and in relation to rights issues, is very much a matter for the market. However, we note that there is a real risk that a considerable number of firms that do not wish to disclose their trading strategies will hover below whatever threshold is set, and that if the threshold is set too low, this may ultimately prove to have harmful consequences for market quality (including, in particular, liquidity) and bid offer spreads.

8.2 So far as the regime for disclosure of short positions in rights issues is concerned, it appears to us that the ongoing disclosure obligations should match the general regime. The present lack of a requirement to make a disclosure when the position falls below the minimum threshold under the rights issue disclosure regime has caused some confusion in the market and has the potential to be misleading. We also question whether these requirements should be reconsidered in light of the wider reforms anticipated to the process of undertaking rights issues, with particular reference to the shortening of the associated time periods.

9 Market maker exemption – question 19

9.1 We agree that there is a need for an exemption for market makers when acting in that capacity. We understand that the market is broadly content with the definition that has been adopted for the purposes of the temporary measures. We note that this differs from the definitions in various directives including the Markets in Financial Instruments Directive, the Transparency Directive and the Acquisitions Directive, but that to some extent it reflects interpretations of those Directives in other Member States.

10 Further measures in respect of CDS

10.1 We do not consider that a case has been made for the imposition of any specific restrictions on credit default swaps. The market abuse regime adequately covers behaviour that involves the manipulation of CDS spreads to potentially profit from short equity positions. We note that further work is being done at European level in relation to CDS instruments generally and in relation to the scope of the Market Abuse Directive, and it would be appropriate to defer consideration of this issue pending the outcome of this work.

There are also a number of points of detail in respect of the current disclosure regime which have given rise to issues for clients, notably the calculation of derivatives positions on a delta-adjusted basis and the position of baskets and indices. These are matters which we would wish to consider further once the international and European position is clearer, and more detailed proposals have been formulated. It occurs to us that the practical operation of the new FSA regime for the disclosure of contracts for differences and other equivalent derivative positions will be relevant to the finalisation of the approach to be taken in relation to these matters under any permanent short selling measures.

Please let us know if you wish us to clarify any of our responses, or suggest more specific proposals.

Yours sincerely

Margaret Chamberlain
Chair CLLS Regulatory Committee

Members of the CLLS:

Chris Bates, Clifford Chance

David Berman, Macfarlanes
Peter Bevan, Linklaters
Patrick Buckingham, Herbert Smith
John Crosthwait, Slaughter and May
Richard Everett, Lawrence Graham, LLP
Robert Finney, Denton Wilde Sapte
Ruth Fox, Slaughter and May
Jonathan Herbst, Norton Rose
Mark Kalderon, Freshfields Bruckhaus Deringer
Tamasin Little, S J Berwin
Simon Morris, CMS Cameron McKenna
Rob Moulton, Nabbaros
Bob Penn, Allen & Overy
James Perry, Ashurst
Peter Richards-Carpenter, Mayer Brown International
Richard Stones, Lovells