TREASURY, RISK AND FINANCE PROFESSIONALS

The Association of Corporate Treasurers

Comments in response to
DP09/01 Short selling
A discussion paper from the FSA
February 2009

21 May 2009

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org .

Contact details are also at the back of these comments.

We canvas the opinion of our members through various member events and more specifically our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter. In making this response The ACT is approaching the subject taking into account the particular interests of corporate issuers of securities.

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On previous occasions, notably in connection with the Disclosure of Contracts for Differences[1] the ACT policy position has been to allow free usage of instruments that are proper and legitimate elements of a good capital market, but that any dangers of abuse or disorderly markets should be addressed via disclosure to the market.

Publicly listed companies take a close interest in the performance and volatility of their equity and the effect on cost of equity and cost of capital generally. To promote an efficient and fair market companies will normally want to ensure there is a good flow of information to the market and that all parties with significant interests in the equity of the company are aware of and understand this market information. Although short sellers do not have a positive ownership interest in the company their behaviour can be influential on the performance and volatility of the shares and therefore the company, and the market, have reason to want to be aware of who the significant short sellers are and their activity.

[1] ACT Response to FSA CP07/20 – Consultation on Disclosure of Contracts for Difference, available at http://www.treasurers.org/node/3183

We regard short selling as a perfectly legitimate transaction and one that contributes to liquidity and price formation and therefore agree with your conclusions that an outright ban is normally not appropriate, but that some form of new disclosures would be an appropriate control over abusive behaviour and would contribute to a well informed market.

Specific questions

There are certain questions where we have not responded and where others closer to market operations are better placed to comment.

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

A1 No comment

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

A2: We agree with your paper that short selling has the capacity to be used abusively, but that short selling of itself is a perfectly legitimate activity and can contribute to the liquidity and price formation within the market, or be used as a tool for managing long positions already held by investors. We see not necessity to ban short selling in any of its forms. However when it come to the definition of short selling or short positions we would want to make sure that shorts created via derivative transactions are included.

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

A3: While there is perhaps a greater risk of problems from naked short selling again we see such transactions as legitimate an no necessity to be banned. Quite apart form this we agree with FSA comments that distinguishing what transactions are naked could be difficult in practice.

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

A4: No. While some may argue that financial sector stocks are more vulnerable to rumours and loss of confidence in essence we see no reason to distinguish between them and other 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?

A5: Around the time of a rights issue there may be additional reasons why short selling is undertaken and again we see no reason to ban such activity, although we do see this as a particularly sensitive period and therefore enhanced disclosures would address the increased risks. See A 20. During a rights issue it would be reassuring to issuers and the market to know that the FSA was being especially vigilant.

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)?

A6: Your discussion paper explains there are risks that underwriters use short selling strategies to mitigate their risk from underwriting. As also explained in the paper there are a variety of constraints on underwriters including their contractual terms, insider dealing rules and existing short disclosure rules. We therefore agree that you should not ban underwriters from short selling.

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?

A7: As an emergency measure we believe that the FSA having the power to intervene and ban short selling would act as a good deterrent. You mention that you think it most likely that this would only be used in relation to the financial sector but we see no reason to limit in this way your powers or readiness to intervene. Non financial sector stock could be just as vulnerable, particularly for a company that is subject to existing negative pressure from its trading performance or through its plans for a rights issue.

The FSA's action would, almost certainly, be after the event – in response to market perturbation caused by short selling – rather than pre-emptive before it occurs. Dealing causing the concern to which the FSA responds would therefore not be caught. However the position created would not benefit from pressure of further short selling. This would be a deterrent to short selling of the kind the FSA might be concerned about.

But disclosure of short selling would often stabilise the market itself.

Accordingly, if a proper disclosure regime were in place, we would expect use of any powers under any provision implementing Q7 would be rare.

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

A8: No comment.

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

A9: No comment.

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.

A10: No

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

A11: The FSA is in a better position than the ACT to assess the costs and benefits. We would be concerned if the compliance costs were such as to reduce the overall levels of short selling in a way that impaired the proper functioning of the market, but we cannot imagine that this would be the case. However the influence on conduct by companies being less concerned about short selling are likely to be positive (companies less likely to be more risk averse) is likely to have a positive influence in the economy.

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?

A12: In recent months there have been particular sensitivities around financial sector stocks, but fundamentally any problems arising from short selling could materialise in any sector of company. Any new obligations should fairly apply to all companies. It would be a distorting error to single out one sector from others.

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

A13: Cross border regulation always introduces the need for a dividing line. In this instance we would tend to support having the rules apply to any stocks traded on a UK exchange since the purpose is to contribute to orderly non abusive markets here, irrespective of country of incorporation of the issuer. However, where the UK listing is a secondary listing there are practical difficulties unless similar rules apply to the exchange of primary listing. In the case of secondary listings the FSA should be able to use its discretion. However, any new rules should apply to primary listings irrespective of the place of incorporation of the issuer.

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

A14: Your paper explains that one model for compiling data on short positions is to require all short trades to be flagged as such and have the information aggregated via the trading platforms. Knowledge of aggregate shorts is surely useful information to the market. But for the market and the issuer themselves knowledge of the identity of holders of significant short positions is also important. This allows the issuer to take appropriate actions to understand strategies and motivations of the investors and ensure that they have access to good and up to date information on the company.

While knowledge of the aggregate of shorts may be useful we see complications in gathering the data accurately and maintaining that data. Not only would sales have to be tagged as shorts but any purchases closing a short would be needed to noted too. In terms of understanding the market trading dynamics you mention that proxy information like stock lending information could be an indicator and in any case volumes of buying and selling orders are already available.

We suspect that the costs of such a system for aggregated short positions would be disproportionate to the benefits, not least because of the unreliability of the end result.

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

A15: We agree with your conclusions. (See A14, above)

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

A16: At first glance, an issuer has less reason to be interested in short positions that are offset by long positions so that disclosure of net shorts is delivering the most relevant information. However, if the investor should have a disclosable long position

which is at some point materially reduced by a short position it would be potentially very misleading for the short position not to be notified.

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?

A17: We feel that 0.50% is of the right order, but the FSA will have better access to market data then we do so we are prepared to accept your recommendations here.

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?

A18: We do agree that a banded approach is a good way reducing the reporting burden and, for users, reducing "noise". As for the previous question the ACT is not in a position to take a definitive position of these bands. However we would make the comment that intuitively 0.1% appears a very narrow gradation. We wonder if something like 0.25% would avoid excessive numbers of disclosures without loss of utility.

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? Do you also agree that this should be an absolute exemption?

AQ19: We agree, subject to oversight to ensure this is not abused.

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?

A20: We agree with having a lower initial threshold for disclosures during a rights issue. As previously mentioned a rights issue period is a particularly sensitive period for an issuer and enhanced vigilance and disclosure would help mitigate the risks.

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

A21: For simplicity the ongoing disclosure bands during a rights issue could sensibly remain at the same percentages as in the normal regime, although in A18 we did question whether normal bands of 0.1% were too narrow.

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

A22: Your paper explains that there can be a correlation between CDS spreads and equity prices. This is a reflection of the idea that in financial distress, bonds begin to have some of the characteristics of equity. The market in CDS is narrow, lacks two way pricing and with the limited number of creators, it is credible that the CDS market is more manipulable than that of listed equities. Manipulation of the CDS spread could feed through into share prices. CDS could, then, be treated under the same sort of disclosure regime as shares.

Unless clear evidence appears to imply that abusive trading is occurring we agree that further measures to cover CDS are not required, and as you mention existing market abuse rules could be applied in any case.

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ACT

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf

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