CFA UK is a member society of

Short selling

DP 09/1

A response by

CFA Society of the UK

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About CFA Society of the UK

The CFA Society of the UK (CFA UK) represents the interests of more than 8,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members.

CFA UK supports the CFA, Associate (ASIP) and IMC designations. Most members hold either the Chartered Financial Analyst (CFA), or Associate designation. CFA Institute is best known for developing and administering the CFA curriculum and examinations and issuing the CFA Charter. CFA Institute's mission is to lead the investment profession globally by setting the highest standards of ethics, education and professional excellence.

Most CFA UK members also belong to the CFA Institute and reaffirm annually their adherence to its Code of Ethics and Standards of Professional Conduct. Both CFA UK and CFA Institute are committed to providing members with a wide range of continuing education opportunities. All members are encouraged to undertake ongoing post-qualification continuing education.

CFA UK is the awarding body for the IMC, the benchmark entry-level qualification for those working in investment management in the UK. The examination is accredited by the Office of the Qualifications and Examinations Regulator (Ofqual) and is designated a recommended examination by the Financial Services Skills Council (FSSC) for the purposes of the Financial Services Authority's training and competence requirements. The IMC is held by more than 15,000 investment professionals.

About this response

CFA UK welcomes DP09/01 on short selling and appreciates the opportunity to comment on the role and value of short selling and to respond to the FSA's specific questions regarding the future regulation and disclosure of short selling.

Covered short selling plays an important role in price discovery and liquidity in the securities markets. The introduction in different markets world-wide of temporary bans on short selling was a response to suspected abuse and disorderly markets in financial stocks. With the benefit of hindsight, it has become clear that the market's actions were a logical response to the deteriorating financial position of stocks in the financial sector. The regulatory response, though well meaning, was inappropriate.

As a recent BlackRock report points out, 'There has been extensive research into the relationship between short-selling, the stock loan that facilitates it, and changes in share prices. According to Professor Charles Jones, Chair, Finance and Economics Division, Columbia University, "virtually every piece of empirical evidence in every journal article ever published in finance concludes that without short sellers, prices are wrong". As the report goes on to point out 'Short interest [in restricted UK financials], as measured by market capitalisation on loan, was low, was falling significantly before the ban, fell further during the ban, and remained low even after the ban was lifted. For the duration of the ban, restricted UK financials performed worse than the market as a whole despite the absence of new short positions.'

A recent EDHEC publication authored by Abraham Lioui, professor of finance at EDHEC Business School, reaches similar conclusions based on an analysis of French financial stocks where short-selling was prohibited. States Lioui's report: 'The ban on short selling was followed by a sharp rise in the volatility of the markets, and on the stock markets concerned the impact of the ban was systematic; the impact on volatility was greater than that of the financial crisis. In general, the risk/ return possibilities of investors worsened. And although it is hard to substantiate the impact on the volatility of the shares, the rise in the volatility of these shares, which is undeniable, is a result of the rise in idiosyncratic risk and thus of the noise in the markets. As a consequence, share prices deviate yet more from their fundamental value. Finally, the desired effect on market trends has not been achieved (no reduction of the negative skewness of returns is being observed) and there is no evidence of the possible impact of this measure on extreme market movements.'

The EDHEC report concludes that market participants viewed the bans as indicative of a deviation of the market authorities from their primary mission. CFA UK shares that view. Among the FSA's responsibilities is the promotion of efficient, orderly and fair markets. There is no good evidence that short-selling activity contributed to the disorderly and illiquid nature of markets in the second half of 2008, but there is a growing body of evidence that the partial ban on short-selling had a damaging effect on market conditions.

The March report of the European Securities Markets Expert Group (ESME) to the European Commission reached similar conclusions. The reports executive summary stated:

- For at least 25 major equity markets worldwide restrictions on short selling were implemented in September 2008, the anticipated effectiveness of which have not been borne out by the evidence.
- In its analysis ESME emphasizes the lack of statistical evidence on the effectiveness of the recent measures and the serious uncertainties, compliance cost and burdens due to a lack of international consistency.
- Overall, short selling restrictions should only be applied in extreme circumstances as a short term response to a specific event; they should not be applied as a matter of course or as a regular feature of equities markets.

- Further consideration should be given as to whether there is merit, on a cost/benefit analysis, in the introduction of a disclosure or transparency regime.

As the ESME report suggest, the occasion of the restrictions on short-selling represents a useful opportunity to review the disclosure regime relating to short-selling. In previous submissions relating to short-selling, CFA UK has expressed its view that short selling is a necessary part of the functioning of a liquid market and nothing should be done which would inhibit the legitimate use of that practice. Consistent with the society's belief in openness and transparency, CFA UK supported the FSA's introduction of new provisions in the Code of Market Conduct, but did so with some reservations due to apparent anomalies in disclosure. As our August 2008 letter pointed out, the society was concerned that:

(i) Long positions had to be reported on a gross basis but short positions on a net basis. Thus an investor with a 10% long position and a 10% short position (zero net position) would be required to report the long position but nothing more. This would mislead, rather than inform, the market.
(ii) The 0.25% short reporting requirement was perverse as it required no disclosure when the short position rose further or fell below that level.
(iii) It appeared illogical to require aggregate short positions of discretionary clients but not (it would appear) of separate legal entities.
(iv) It was not obvious why the reporting requirements should apply to the equity of non-UK companies with non-UK primary listings.
(v) It was not logical to propose disclosure of short positions only during a rights issue period. Capital markets should have a consistent set of rules which offer transparency and protection at all times.
(vi) It was not logical to have different thresholds for short-selling from those which apply to long positions. We therefore argued for higher thresholds on a symmetrical basis with the long disclosure rules.

In order to assist the society in its response to DP 09/1 (and as a check to ensure that members' views had been properly represented in our prior communication) the society surveyed its membership on a number of the specific issues contained in the DP. Three hundred and forty-seven members participated in the survey with 90 of those members submitting additional text comments to support their survey responses.

In addition to asking members to provide feedback on specific questions raised in the DP, CFA UK also asked members to comment on whether or not there should be symmetrical disclosure requirements for long and short regimes. Of the 346 respondents, 24% strongly agreed, 40% agreed, 18% disagreed, 11% strongly disagreed and 6% had no view. The society's view remains that symmetrical disclosure obligations are justified and fair.

The survey results are contained in this response as Appendix A.

Last, as a member society of CFA Institute, CFA UK is aware of the desirability of international cooperation and coordination to improve market efficiency widely and to reduce costs to market participants actively investing across global markets. We applaud the FSA for its understanding of the need for international coordination and for its willingness to delay implementation of new measures relating to short selling disclosures until such time as greater information is available as to the approaches that might be taken elsewhere.

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

There is no evidence that a blanket ban on short selling would generate any benefits in relation to the promotion of efficient, orderly and fair markets, but there is a growing body of evidence that demonstrates that banning short selling significantly impairs market function to the detriment and cost of all market participants.

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

Yes

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

As the ESME report notes, 'naked short selling can be used abusively and can contribute to disorderly markets'. However, the report adds that 'these types of risks are considered insufficient to warrant a ban on short selling, as the potential for providing access for market abuse is an element that applies equally to purchases and therefore should not be considered unique to short selling alone. Additionally, it should be noted that the potential for market abuse is also dealt with by the Market Abuse Directive and related legislation.' Similarly, we share the experience reported in the BlackRock case and 'have not seen evidence on any material settlement failure in UK financials that would be attendant to any such naked shorting and, so, do not believe naked shorting is prevalent.'

However, CFA UK would support further steps taken to address late settlement issues in order to enhance market efficiency and further limit the scope for naked short selling.

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

No, for the reasons stated above in Q1.

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?

Yes, while we accept the argument that rights issues might be vulnerable to short selling this vulnerability ought to be adequately balanced by a satisfactory disclosure regime. It remains important for short selling to be allowed in all stocks in order to promote efficient, orderly and fair markets.

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)?

Yes.

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?

No. The framework regulating short selling should be sufficiently robust and adequately maintained (via continued feedback from market participants) to prevent disorderly markets occurring as a consequence of short selling. Maintaining the right to intervene on an emergency basis might lead to a continuation of the incorrect assumption that short-selling can create disorderly markets. Similarly, the regulatory framework for identifying and penalising market abuse should be sufficiently robust to discourage abusive behaviour in the form of naked short selling.

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

Yes.

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

Yes. As DP 09/1 points out, the costs of introducing a tick rule are substantial, but there is no evidence that a tick rule improves market efficiency. As the 2007 SEC study identified, the tick rule actually led to a modest reduction in liquidity.

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.

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

This question is poorly framed. Improved transparency in relation to short selling would be beneficial – not least in dispelling the widespread, but false assumption that it imposes a cost on markets to the benefit of the few – but not at any cost. The FSA should work with markets to identify minimum acceptable standards of disclosure and should then build on those by adding further measures aimed at diminishing degrees of marginal utility until the benefits of any further steps are clearly not balanced by reasonable costs.

However, CFA UK and CFA Institute both share a firm belief in the need for timely, accurate and transparent disclosure and would, on balance, support the view that the benefits of disclosure outweigh the costs.

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?

Yes.

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

No. As stated in our communication of August 2008, CFA UK believes that the reporting requirements should apply to the equity of all companies with a UK primary listing. DP 09/1 correctly identifies the need for a level playing field and the danger of stocks being sold short as a proxy for other stocks where there are discrepancies in reporting requirements across sectors.

While our initial concern is to the proper functioning of the UK market, it is clearly important for there to be equivalence in disclosure obligations across international markets and CFA UK would recommend that, at a minimum, European regulators cooperate in order to promote broadly equivalent regimes across European markets.

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

No. The initial costs of introducing an aggregate short position disclosure regime would be extensive and might not be matched by benefits over the short-term, but there may be an improved return over the longer-term. In the interests of improved disclosure, likely to lead to improved market efficiency, CFA UK would support the introduction of an aggregate short position disclosure regime.

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

DP09/1 does not adequately quantify the costs to the markets of the loss of short activity as a consequence of the need for public disclosure. The potential difficulty of closing short positions disclosed to the market is real and may discourage marginal participants. In addition, society members are concerned that public disclosure of short positions might lead to irrational responses from the management of companies whose stock is being shorted leading to a lack of access to management. Further, CFA UK does not support the view that public disclosure generates a benefit by discouraging aggressive short-selling leading to disorderly markets. As stated previously, CFA UK does not support the view that short-selling destabilises markets.

However, CFA UK believes in the value of disclosure and, on balance, agrees that the benefits of disclosure probably outweigh the costs.

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

Yes. When questioned by the society, the majority of respondents 64% either agreed strongly or agreed with the recommendation to report on a net basis. 29% of respondents either disagreed or strongly disagreed with the recommendation and 7% had no opinion on this issue.

In further comments, CFA UK members noted that the guidelines for net position disclosure ought to specify that net exposures should be defined at the individual investor or fund level and that they should be calculated as the long cash and derivatives exposure less the short cash and derivatives exposure and that where stock exposure was being netted off against an index future, only the proportionate weight of that stock in the index could be netted off. However, members also observed that a simple way to avoid the disclosure requirement would be to purchase an offsetting long position via a call option in the security that was well out of the money. Disclosure of both gross and net positions might be a preferable solution in the long-term.

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?

No. When questioned by the society, 43% of respondents either agreed strongly or agreed with 0.5% as an appropriate threshold for a net short position disclosure regime. 39% of respondents either disagreed or strongly disagreed with the recommendation and 18% had no opinion on this issue. However, the proposal runs counter to the society's belief that there should be symmetry between disclosure requirements for long and short positions. As the Hedge Funds Standards Board summarised in its January 2009 response to CESR's call for evidence on short-selling:

- 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.

In members' additional comments, there was little support for the proposal. Most respondents argued for a higher threshold and/or for symmetry with the threshold for disclosure of long positions. This has been the society's position in previous correspondence with the FSA. A number also suggested that imposing a single threshold for all disclosures – irrespective of the relative liquidity of different securities – was the wrong approach altogether and that if asymmetric thresholds were introduced, these should be based on relative liquidity.

As an additional final note on this question, we support the FSA's view that an international consensus on disclosure requirements would be valuable and agree that a final determination on the approach to adopt should not be reached until further information on other international proposals is available and has been carefully considered.

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?

As described in our response to Q17, CFA UK does not support the 0.5% disclosure requirement, preferring symmetry with the disclosure requirements for long positions.

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?

When questioned by the society, 63% of respondents either agreed strongly or agreed that market makers should be exempt from disclosure obligations when acting in the capacity of a market maker. 31% of respondents either disagreed or strongly disagreed with the recommendation and 7% had no opinion on this issue.

In members' additional comments, concerns were raised about the potential for abuse based on the difficulty of determining whether or not a market-maker is acting at all times in that capacity. While members understand and appreciate the need to provide an exemption on disclosure obligations for those running a balanced book over the medium-term in order to support liquidity, there were concerns that market-makers would shift their character from agency to principal or might rent their ability to short without disclosure. Members also noted that if liquidity provision is the basis for exemption from disclosure requirements, then other market participants, such as market neutral hedge funds, might also make a reasonable case for exemption.

In comments, many members suggested that if the disclosure threshold was raised to 1%, then there would be less need for market-maker exemption and the danger that the exemption could enable abuse would be avoided.

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?

No. CFA UK has stated previously that it is not logical to propose disclosure of short positions only during a rights issue period. Capital markets should have a consistent set of rules which offer transparency and protection at all times. The society recommends that disclosure be symmetrical for that relating to other net short and long positions.

When questioned by the society, 39% of respondents either agreed strongly or agreed that the current disclosure obligation of 0.25% for rights issues is appropriate. 26% of respondents either disagreed or strongly disagreed with the recommendation and 34% had no opinion on this issue.

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

Yes.

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

No.