KAYE SCHOLER LLP | INVESTMENT FUNDS GROUP

Once More, With Feeling: The FSA Issues Discussion Paper on Short Selling

On 18 September 2008, the Financial Services Authority ("FSA") introduced a temporary ban on the short selling of certain UK financial sector stocks, along with a disclosure requirement for significant short positions in those stocks (0.25% of the relevant firm's issued share capital). At the same time, it announced that it would undertake a comprehensive review of short selling. The fruits of that review are contained in the FSA's discussion paper issued on 6 February 2009.

The FSA had already given a clear hint as to their preferred policy last month, when the ban on short selling was allowed to expire, but the requirement to disclose significant short positions to the market was retained. It is thus no surprise that the FSA's starting position is that, though short selling is a legitimate investment technique in normal market conditions, the case for improving the transparency of short selling is such that disclosure obligations should be continued (albeit operating on a higher disclosure threshold: 0.50% of issued share capital). Equally unsurprising is that the FSA's preferred method of disclosure remains on an individual basis, where the aggregate net position is disclosed to the market as a whole, as opposed to other disclosure methods (such as disclosure privately to the FSA). However, the FSA is also proposing that the current restricted short selling disclosure should apply to all stocks and their related instruments. This is likely to cause a significant increase in costs to market participants (as the FSA itself concedes), and the FSA advances no argument in favour of the extension, other than consistency and the fact that it is difficult to predict which market sectors might be vulnerable in the future to abusive behaviour or disorderly markets. Given that the FSA has tools to deal with the latter in the existing market abuse regime, and it reserves the right to intervene to ban short selling on an emergency basis should it be required by market conditions, it is difficult to see the FSA proposals as a proportionate response.

The FSA's initial ban on short selling was the subject of some trenchant criticism from market participants and their trade associations, and the FSA is understandably keen in the discussion paper to put the best emphasis on the action that it took. The line that the FSA adopts is that market conditions led to a "heightened (and unacceptable) risk of abusive behaviour and resultant disorderly markets through short selling", and that this "had the risk of being self-fulfilling through the impact on financial institutions' funding mechanisms"; as a result of the FSA's intervention in September 2008 "this risk has not been visible". But this plays down two significant aspects. First, the collapse in the share prices of certain UK financial stocks continued after the ban on short selling, leading to the UK government taking significant stakes in several high-street banks. This suggests that any short selling of those stocks could not have been a significant cause (if indeed it was a cause at all) of their decline in value. Secondly, the FSA observes that it is very difficult to establish whether the temporary ban on short selling had any significant effects (in particular, whether it "caused" anything). This in itself is a major concession, and the argument in favour of the short selling ban leading to any tangible achievement is further undermined by the observation that, though trading volume for the restricted stocks declined significantly during the period of the ban, there was no less volatility in the shares on the restricted list in the period of the ban than in the matched sample of shares that were not so restricted.

Interested parties have until 8 May 2009 to comment. The FSA notes that there are working groups on short selling at both European (Committee of European Securities Regulators) and international (International Organisation of Securities Commissions) levels, and that the widest possible degree of consensus on the mechanics of a short selling regime would be desirable. Market participants can thus expect the FSA paper to be the first of many in this area.

Chicago Office
+1 312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1 310.788.1000

New York Office
+1 212.836.8000

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1 202.682.3500

West Palm Beach Office
+1 561.802.3230