

# Response to HMT Short Selling Regulation Review: Call for Evidence

## About the Investment Association

The Investment Association (IA) champions UK investment management, supporting British savers, investors, and businesses. Our 250 members manage £10.0 trillion of assets and the investment management industry supports 122,000 jobs across the UK.

Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital.

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs.

The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

## Executive summary

Overall, the IA supports the continuation of the short selling regime, given short selling plays an important and beneficial role in the orderly and effective functioning of financial markets. Amongst other benefits short selling aids liquidity, price discovery and risk management. However, we do consider that there are areas of the regime which could benefit from reform notably:

### **The Public Disclosure Requirements:**

- The IA recommends that public disclosure requirements are repealed in their entirety, given the unintended consequences these requirements can have on the market including but not limited to exposing the market to manipulation including copycat behaviour, price squeezes and increased volatility; and
- Should this not be a viable option then the IA would suggest consideration is given to aligning the short selling regime to the regime implemented for long selling.

## The Investment Association

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## **Disclosure requirements – position reporting to the FCA:**

- IA members consider the reinstatement of the reporting threshold to 0.2% would be an improvement on the current situation. However, this threshold is still extremely low when compared to the 3% threshold set under the Transparency Directive for long positions. Therefore, we recommend an initial threshold of 0.5% is set.
- We also suggest that a cost benefit analysis is undertaken, including reaching out to individual member firms to better understand the implications firms face in submitting position reports to the FCA at such granular levels.

## **1. Chapter 1 – Introduction**

### **Scope of Short Selling**

#### **1) Do you agree that the activity of short selling plays an important role in the efficient functioning of financial markets?**

The IA and its members echo the FCA's stance that short selling plays an important and beneficial role in the orderly and effective functioning of financial markets. In particular short selling supports liquidity, price discovery and risk management, all of which increases market confidence.

As short selling can be thought of as a form of insurance which protects an investor against short-term losses in a long-term investment, it is a particularly useful tool for investors during times of volatility, or to mitigate against uncertainty. For example, when the value of a pension funds' investment portfolio may be declining in value because of stock market performance, short selling can provide a source of income which makes up some, if not all of the difference.

During these volatile moments short selling also helps maintain liquidity, meaning more trades take place, which in turn allows for a more accurate valuation of the company and helps to reduce the cost of trading for investors. It therefore assists the market in incorporating new information into pricing more rapidly than otherwise would be the case.

#### **2) Do you think that the activity of short selling should be regulated in the UK? Please briefly explain why or why not**

Yes, we do.

IA members agree that the activity of short selling should continue to be regulated in the UK by the FCA. The FCA should continue to have powers to oversee the market for short selling and maintain powers to intervene where appropriate.

The IA and its members recommend that it may be beneficial to the industry if the FCA were to provide further clarity around the circumstances in which the FCA would consider it appropriate to intervene.

#### **3) Do you think the SSR puts a proportionate regulatory burden on short sellers in the UK market? Please briefly set out why.**

Whilst we understand the FCA's need for quality data on short selling activity to ensure they can make informed, evidence-based decisions regarding any supervisory action that may need to be taken we do consider that the regime requires simplification.

Since the lowering of the supervisory notification threshold from 0.2% to 0.1% in 2020, IA members report a significant increase in required reports, including the number of filings that have to be submitted to the

FCA. The IA and its members question whether the lowering of the threshold and the subsequent increase in data received via the responses filed has resulted in an increase in meaningful data, or, if the increase in data simply delays the FCA's overall ability to identify concerning market activity based on the sheer increase in volume.

Overall, our members conclude that when considering the SSR framework in its entirety it is the public disclosure requirements which are the greatest burden on short sellers and require significant reform. For example, these requirements can expose the market to manipulation including copycat behaviour and price squeezes resulting in increased market volatility. This means that price movements occur based on these disclosures and not based on fundamental market activity. Furthermore, the requirement to disclose and file 10 basis point changes in short positions is not only burdensome but also unnecessary. Instead, we recommend that only large moves are disclosed, as in long investing.

We would also suggest the FCA consider exploring the use of Primary Broker data to internally corroborate any findings from the data submitted under the transparency reporting requirements.

#### **4) Are there aspects of the SSR which you consider to be essential for ensuring market stability and confidence in the activity of short selling?**

As noted in our response to Q1, short selling plays an important and beneficial role in the orderly and effective functioning of financial markets, in particular short selling aids liquidity, price discovery and risk management all of which increase confidence and efficiency in the market.

Short selling can also be thought of as a form of insurance which protects an investor against short-term losses in a long-term investment, it is a particularly useful tool for investors during times of volatility, or to mitigate against uncertainty. For example, when the value of a pension funds' investment portfolio may be declining in value because of stock market performance, short selling can provide a source of income which makes up some, if not all of the difference.

#### **5) In your view would it be preferable to modify the existing SSR to reflect the UK markets, but keep the core framework unchanged, or do you think there is a case for fundamental reform?**

In the first instance, the IA strongly urge the FCA to consider repealing the public disclosure requirements in their entirety.

Should this not be a viable option, the IA and its members question why the short selling regime remains vastly different to the rules established for long selling (as set out in the Transparency Directive) and suggest that the same considerations should be given to short selling that are given to long selling.

If this also poses significant complexity for the FCA, IA members would support modification of the existing SSR framework to better reflect UK markets. In particular our members propose the following:

- a higher threshold of 50 bps (0.5%) for regulators' notifications
- a higher threshold of 100 bps (1%) for public disclosure
- repealing the requirement to declare position holder identity

As noted in our response to Q4, the regulator may want to consider exploring the use of Primary Broker data to reconcile any of the data submitted under the transparency reporting requirements.

## **6) Are there aspects of other jurisdictions' short selling regulations that you think operate better than the SSR?**

After reflecting on other jurisdictions short selling regulations, we would like to take the opportunity to commend the pragmatic approach taken by the FCA with regards to the application of short selling bans. The FCA's measured and limited approach to its use of such powers has been more effective in ensuring the continuation of functioning markets than the approaches undertaken by some other jurisdictions during certain moments of market uncertainty.

## **Chapter 2 – The Short Selling Regulation**

### **Restrictions on 'uncovered' short selling**

## **7) Do you consider that uncovered short selling restrictions under the SSR are appropriate?**

The IA and its members consider it appropriate that the regulatory framework for short selling continues to restrict the possibility for uncovered short selling.

## **8) Do you consider that current uncovered short selling restrictions are working effectively to reduce risks to settlement and the orderly functioning of the market, in particular current locate arrangements? What arrangements do you use and why are they effective?**

IA members consider that the existing locate arrangements function effectively and do not require any amendments.

## **9) Is short selling activity causing settlement failures? Do current UK settlement discipline arrangements need to be changed to reduce the risk of short selling causing settlement failures? What changes could be made and why?**

The IA considers it appropriate that the regulatory framework for short selling continues to restrict the possibility for uncovered short selling. IA members acknowledge that uncovered short selling can potentially create operational issues and increase fails in the market which would have further implications for the buy-side.

### **Disclosure Requirements – position reporting to the FCA**

## **10) Should the FCA specifically monitor short selling?**

Yes.

Furthermore, it is the view of our members that more of the monitoring should be undertaken by the FCA and not as a result of the public disclosure requirements. The public disclosure requirements create inefficiencies and opportunities for manipulation. For more information, please see our response to Q11,12 & 17 which further expands on our reasoning as to why the FCA should monitor short selling.

**11) Does the FCA monitoring of short selling help support market integrity and market confidence?**

Yes.

IA members agree that the FCA should continue to monitor short selling for market integrity and market confidence purposes. As outlined in our response to Q2 it would be of benefit to the industry if the FCA were to provide further clarity around the circumstances in which the FCA would consider it appropriate to intervene.

**12) What are the costs and burdens for your firm for sending position reports to the FCA? Please provide any evidence. Are there specific position reporting requirements or arrangements that could be changed to alleviate the cost and burdens of reporting?**

Following the lowering of the initial threshold from 0.2% to 0.1% in 2020, IA members who engage in short selling have experienced significant increases in compliance burdens and the number of filings that have to be made to the FCA. The IA and its members urge HMT and the FCA to consider whether lowering the threshold has resulted in an increase in the amount of meaningful data received in order to identify issues of market disorder and, or market abuse, or whether it has simply added to the volume of data reports the FCA receives, which inhibits the FCA's ability to identify genuine market disorder/market abuse.

IA members consider that the revision of the reporting threshold to 0.2% would be an improvement on the current situation where the threshold is set at 0.1%. Nevertheless, the IA stresses that the reversion back to 0.2% is still an extremely low threshold compared to the initial 3% threshold set under the Transparency Directive. As a result, we recommend an initial threshold of 0.5% is set. This would ensure less time and resource has to be dedicated to calculating and submitting reports without compromising on the quality of data the FCA receives, meaning the FCA can still utilise the data provided to assist with identifying market disorder by market participants.

**13) Do you think the current reporting threshold and increments are set at the appropriate level? Do you think there are any benefits or risks associated with amending the current threshold? In particular, would you support reverting the threshold to 0.2%? Is 0.2% still too small?**

IA members, consider the reversal of the reporting threshold back to 0.2% would be an improvement on the current 0.1% threshold. Nevertheless, the IA stresses the reversal back to 0.2% in itself is still an extremely low threshold compared to the initial 3% threshold set under the Transparency Directive. As a result, we recommend an initial threshold of 0.5%, this would be of significant benefit particularly from an operational perspective as outlined in our response to Q12 above.

#### **14) Are there other adjustments to the reporting requirements which you would suggest?**

IA members would encourage the FCA to create a defined list of shares that are in scope of the SSR, thus providing a central golden source for the issued share capital data which includes total shares outstanding.

IA members also suggest that the FCA considers undertaking changes to the submission of notifications to enable bulk upload of notifications and to align the deadline by which notifications for short positions have to be filed with the deadline for reporting long positions.

#### **Public Disclosures**

#### **15) Do you support the requirement to publicly disclose net short positions under the SSR? What would be the impact to your firm or the market if public disclosure requirements were to be removed?**

No. The IA encourages the FCA to consider repealing the public disclosure requirements in their entirety given the unintended consequences these requirements can have on various other aspects of the market including limiting investment research provisions and information flow. Instead, we recommend that only large moves are disclosed as in long investing.

IA members also emphasise that the 0.1% interval for disclosing changed positions is far too granular. Given the granularity of the current reporting levels members note the serious implications this can have on market behaviour including issues of copycat trading, meme stock behaviour and distortions to pricing all of which are behaviours that are not only detrimental to the company concerned but have negative consequences for the wider market (which are further outlined in our response to Q17 & Q18).

#### **16) How do you use public net short position disclosures and how does it support your firm's activity or the market?**

No comment.

#### **17) Do the public disclosure requirements contribute to or create any unnecessary barriers to short selling? If yes, please provide details.**

As previously noted, the IA and its members consider that the public disclosure requirements can expose the market to manipulation including copycat behaviour and price squeezes resulting in increased market volatility. This means that price movements occur based on these disclosures, as members note that it is very easy to establish trading patterns by observing 10bps disclosures on a daily basis and either "front run" a large fund adding to short positions, or front run a fund focusing on reducing exposure. Either would exacerbate price action either to the upside or downside and add to the risk of other participants experiencing near term outsize losses or gains. Thus, price discovery would not be based on fundamental market activity and therefore not a true reflection of the market.

Effective investment research and free flow of information can also be impaired by these disclosures, as the value of investment research can be undermined as active investment strategies can effectively be disclosed through such public disclosures. In turn this is damaging to those who pay active management fees.

Member firms note that public disclosure requirements can also result in issuers withholding information from those who they know are shorting the company, this may impact on the long-term ability to engage

with companies in the future and may impair the free flow of information if such relationships are damaged.

**18) Are there public disclosure requirements that could be changed to remove any unnecessary barriers to short selling? For example, do the identities of the position holders need to be disclosed and what would be the impact on your firm and the market from removing this?**

The IA and its members strongly encourage HMT to consider repealing the public disclosure requirements in their entirety, including the requirement to declare position holder identity and the requirement for “persons to have to publicly disclose incremental 0.1% changes above the threshold” as such requirements can act as a deterrent to partaking in short selling practices resulting in reduced price discovery. Instead, we recommend that only large moves are disclosed as in long investing, with no disclosure of position holder identities.

**19) Do you consider that public disclosure requirements could be improved to increase transparency to the market? What are your views on publishing a net aggregated positions report to supplement or replace current reporting arrangements?**

Currently, the IA’s members tend not to be inclined to support HMT’s suggestion to publish a net aggregated positions report. However, we do note that some IA member firms may potentially be open to considering the above proposal provided net aggregated positions are set at issuer level.

In light of the above, we suggest further detailed analysis is undertaken to ensure a practical and fair solution is found which is palatable for all market participants.

**Market Maker Exemption**

**20) Do you think the current market maker exemption regime in the SSR functions effectiently? Are there aspects of the market maker exemption regime requirements or arrangements that could be changed to reduce burdens and improve its effeciency?**

No comment.

**Emergency Intervention Powers**

**21) Do you consider the FCA should have powers to intervene in the market in relation to short selling activity in exceptional circumstances? What would be the impact if short selling bans were to be removed under the UK regime?**

We welcome the pragmatic approach undertaken by the FCA in relation to the use of their emergency powers. To date, the UK has an extremely limited historical use of short selling bans, demonstrating that the FCA reserves its interventional powers for only the most extreme scenarios.

In addition to the above, members note that the data available to market participants demonstrates that the use of COVID-related short selling bans imposed by some EU countries within recent years has had a rather disruptive impact on the trading landscape resulting in a negative impact on liquidity, increased

trading costs, decreased trading volumes and higher volatility. These outcomes are not restricted to the use of short-selling bans during the pandemic itself but are also mirrored by regulatory and academic studies which map the impact of short selling bans prior to COVID. These studies also demonstrate that previous implementation of short-selling bans resulted in falling share prices across restricted markets and across markets with no short selling bans. Such findings make it difficult for IA members to understand the validity of the bans themselves and suggests that regulators may want to reconsider the effectiveness of implementing short-selling bans in the future.

If the FCA is to maintain its emergency powers, the IA considers that the application of the short selling mechanism within the UK should continue to only be exercised under exceptional circumstances. In order to better understand what qualifies as an exceptional circumstance, our members propose that the FCA provide further clarity on the purpose of short selling bans and explicitly outlines the regulatory and operational parameters for how the bans operate (including explicitly defining what is in scope of the short-selling ban) to ensure effective operational implementation by market participants.

For example, the IA suggests that the regulatory parameters provide:

- a clear indication of the products and sectors in-scope of the ban, including application to derivatives, Depository Receipts (DRs), Exchange Traded Funds (ETFs) and indices (acknowledging respective index weighting exemptions where applicable)
- clarity on the exchanges in-scope
- guidelines on whether the restriction applies to increasing a new short position or creating a net short position (including rolling a derivative where they result in a net short position)
- Further clarity on the applicability of short selling bans to hedging activity, where there is a genuine need for hedging strategies to continue then these should not fall within scope of the ban.

## **22) Do you think any changes could be made to increase the effectiveness of existing short selling bans?**

As outlined in our response to question 21 the application of the short selling ban mechanism within the UK should continue to be exercised only under exceptional circumstances. In order to better understand what qualifies as an exceptional circumstance, our members propose that the FCA provide further clarity on the purpose and regulatory parameters including the scoping for any ban to ensure effective operational implementation by market participants.

For example, the IA suggests that the regulatory parameters provide:

- a clear indication of the products and sectors in-scope of the ban, including application to derivatives, Depository Receipts (DRs), Exchange Traded Funds (ETFs) and indices (acknowledging respective index weighting exemptions where applicable)
- clarity on the exchanges in-scope
- guidelines on whether the restriction applies to initiating a new short position or creating a net short position (including rolling a derivative where they result in a net short position)
- Further clarity on the applicability of short selling bans to hedging activity. Where there is a genuine need for hedging strategies to continue then these should not fall within scope of the ban.

In the case of extreme and global systemic events, the IA and its members support consideration being given by regulators across jurisdictions to potentially implementing a globally coordinated approach when



considering implementing bans to ensure consistency in application. Inconsistent application of short selling bans across different jurisdictions can cause unnecessary complexity and confusion, resulting in regulatory arbitrage. However, we do recommend a cost benefit analysis be undertaken to measure the effectiveness of any ban should it be considered in future.

**23) Are there any alternative arrangements to short selling bans that could be put in place (including arrangements from other jurisdictions)?**

No comment.

**Overseas Shares**

**24) Do you consider that the current requirements and arrangements for overseas shares are effective? What changes could be made to improve the arrangements for overseas shares under the SSR? Could the overseas shares list be changed to a “positive” list of shares that are required to be reported/covered by market participants?**

IA members would encourage the FCA to create a defined list of shares that are in scope of the SSR, thus providing a central golden source for the issued share capital data which includes total shares outstanding.

**Other considerations**

**25) Please provide any further views on the SSR, including views on the arrangements relating to sovereign debt and sovereign credit default swaps**

The IA will provide detailed feedback on this area of the SSR in due course and when required, as we note under paragraph 1.16 of the Call for Evidence that HMT states that the focus of this review is “*not to explore other provisions in the SSR including the short selling regime for UK sovereign debt and UK credit default swaps [... as] this government will consider [this] later as part of the process to repeal retained EU law in this area and replace it with a regulatory framework tailored to the UK market.*”

**26) For firms operating in multiple jurisdictions, please provide views on the potential operational impact of changes to the UK short selling regime (e.g. IT changes).**

Should HMT and the FCA decide to revise the UK’s short selling regime, our members consider that any short-term operational costs which may be required to facilitate the modifications would likely yield long term benefits.

Furthermore, IA members consider that given many firms have already undertaken IT adjustments to accommodate Brexit related changes the operational impacts required to accommodate for any revisions to the UK’s SSR should not be too intensive to implement given the infrastructure is already in place.