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January 29th, 2003

Margot Marshall
Markets and Exchanges Division
The Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Ms Marshall,

DP17: Short selling

I am writing to provide the comments of the International Swaps and Derivatives Association on the FSA's Discussion Paper on short selling.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 600 member institutions from 46 countries on six continents. These members include the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site, www.isda.org.

We welcome the opportunity to comment on the Discussion Paper. In particular, we welcome the FSA's positive approach to short selling practices. We strongly share the FSA's view that short selling is a legitimate investment activity that plays an important role in supporting efficient markets. In particular, short selling is an essential part of many strategies for the use of OTC derivatives.

Therefore, we agree that there is no basis for a ban on short selling or the imposition of specific regulatory constraints. In particular, we do not believe that it would be appropriate to introduce a "tick" rule to limit the use of short selling.

Even if it was true that short sales contained information of value to other market users, DP17 is effective in illustrating some of the conceptual and practical difficulties in trying to disclose more information in a way that is genuinely useful to market participants yet does not impose excessive burdens.

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The Paper sets out six “Options for change”, which we discuss below. To recapitulate, these consist of three relatively broad and three more targeted transparency options, to wit:

- 1) Marking and reporting short sales for cash equities;
- 2) Full disclosure of short positions in both cash and derivatives markets;
- 3) Data on securities lending as a proxy for short selling;
- 4) Disclosure of short sales beyond a certain threshold – Short disclosure to issuers;
- 5) Disclosure of short sales in specific situations [ie, for Naked shorts];
- 6) Directors’ dealings in short sales.

Option 1 (short sales in cash equities) seems unlikely to reveal information that would be of real value to other market participants. As **Option 2** (cash and derivative shorts) then suggests, what would be of interest is disclosure of the extent of open short positions. However, it would be of little value to focus only the fact that a market participant has sold short and covered by borrowing but to ignore the fact that that same participant held an in-the-money call option with a deliverable number of shares in excess of the supposed short position. On the other hand, it would be unrealistic and excessively burdensome to create a scheme that requires every market participant to calculate its individual overall net exposure to particular shares. This would clearly be disproportionately burdensome, bearing in mind that the books of many market participants will contain many different types of instruments, some of which (such as barrier options) may not produce readily calculable absolute numbers of shares of the kind that this arrangement envisages.

Options 1 and 2 also fail to address a crucial issue: to whom any such scheme would apply. It is possible to require foreign investors to disclose long positions in UK companies because, at the end of the day, there is the threat of freezing the rights attached to the shares. It is less obvious how the UK would force non-UK market participants to comply with the envisaged disclosure requirements for short sales, particularly bearing in mind that transactions in UK stocks can take place and be cleared and settled outside the UK (and that Option 2 seems to envisage reporting of positions that result from cash-settled transactions).

Nevertheless, we would support further consideration of **Option 3**. This seems to us to be a more market-led solution. We can see no objection, if CRESTCo can produce information about securities-lending volumes that is of value to market participants (without prejudicing commercial confidentiality or imposing new systems or other requirements). The information will demonstrate its value (or lack of it) in the market.

On the other hand, we do not believe that there is any justification in requiring the reporting of large short positions to issuers along the lines suggested in **Option 4** (Short disclosure to issuers). As the paper points out, this proposal would mean a radical change in the theory underlying the current reporting requirements, which focus on control of voting rights.

If the revised disclosure requirements focused solely on physical positions, they would distort the market against particular trading methods. However, if the calculation was to take cash-settled instruments into account, the proposal would present the same issues discussed above about how to calculate the overall net exposure (and would raise the issue as to whether the same approach should be taken in relation to long positions – in calculating the size of a long position, the requirements currently ignore notional positions underlying purely cash-settled instruments). It also would be necessary to address the question of how to enforce the disclosure requirement against investors located outside the UK. In addition, change along these lines would be inconsistent with the shape of the current EU proposals for revisions to the (Transparency) Directive dealing with the reporting of significant shareholdings.

We also do not believe that there is any value in the proposal to require the reporting of naked shorts, as contemplated by **Option 5**. The appropriate way to minimise the risk of settlement disruption is to ensure that there is a smoothly functioning securities lending market and for there to be adequate incentives within settlement arrangements to avoid fails. In this respect, the exchanges and clearing and settlement systems should periodically review their settlement disciplines to ensure that they provide a robust framework. However, we do not believe that there is merit in compelling firms to use guaranteed delivery for this type of transaction, or to use other methods which increase the cost of trading.

We believe that **Option 6** would be a disproportionate response, in the absence of a clearly defined problem, especially as it seems unlikely that directors would be a major source of short selling.

We hope that this is of assistance. Please contact me if you have any questions on this.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'R. Metcalfe', with a long horizontal flourish extending to the right.

Richard Metcalfe
Co-Head, European Office