AFME and ISDA joint response to

HM Treasury, Short Selling Regulation Review: Call for Evidence

3 March 2023

About AFME

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the Short Selling Regulation Review Call for Evidence. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook, and YouTube.

Executive Summary

- Overall, AFME and ISDA support the existing Short Selling regime. Short selling is a legitimate and useful activity which facilitates price discovery and enhances market liquidity. However, we welcome the opportunity to suggest areas which may benefit from targeted reform.
- AFME members strongly believe that the market maker exemption is critical for the efficient functioning of the market and believe that the current regime generally operates well and do not wish to see any major changes to the exemption.
- There may however be some small improvements that could be made to streamline the requirements. For example, AFME and ISDA members suggest that the 30 days notification period for the market maker exemption and stock-by stock application process could be removed. The market maker exemption is vital for the efficient functioning of the market and therefore streamlining its application and ensuring it can begin to operate in a timely manner would be beneficial to the market.

- We also recommend maintaining the current settlement discipline rules applied by CREST as they sufficiently incentivise market participants to avoid settlement failures without compromising market liquidity.
- Our Members support the proposal of reverting to 0.2% as reporting threshold. the basis that reporting would be fixed at this level.
- Members recommend the FCA to consider short selling bans only as a last resort . Indeed, AFME would like to reiterate that short selling bans represent a significant risk to liquidity and the efficient functioning of the market, as demonstrated during the European short selling bans applied during Covid 19, and we recommend avoiding the adoption of such bans.
- Members support moving to a “positive list” for all shares. This would facilitate the assessment of shares falling under the scope of the SSR, reducing the administrative burden on firms.

1. Role of short selling in the financial market and interaction with other regulations

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

Yes, our members agree with the important role that short selling plays in financial markets, especially from a price discovery perspective.

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

Yes, our members agree that short selling should continue to be regulated in the UK. They would also like to reiterate that the current framework is effective in protecting market integrity and it is well understood by market participants.

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

While members reiterate that the existing short selling framework is appropriate, there are some areas where the SSR could be optimised specifically for UK markets. Specifically, with regards to the notification for market maker exemptions, members would welcome the removal of the 30 days notification period so that the FCA can issue the exemption immediately after the receipt of the notification, as also outlined under question 20. This would provide certainty to firms and streamline the current approach. We also recommend a softening of the stock-by-stock application process, as it is unnecessarily time consuming.

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?

Short selling allows market participants to efficiently hedge their positions, enhancing liquidity in the market and making markets more efficient. Indeed, it improves price discovery and reduces trading costs[1]. According to the paper from the World Federation of Exchanges [on the effect of short selling bans], “higher intraday short-selling activity is related to negative intraday future returns, a hint that short sellers can correctly predict future price movements”. [2]

[1] https://www.nasdaq.com/articles/how-short-selling-makes-markets-more-efficient-2020-10-01
[2] https://www.world-exchanges.org/storage/app/media/short_selling.pdf

The current regulatory framework appropriately protects market integrity without impacting the benefits that short selling can bring to the market. Thus, the bar for reform should be high as significant changes to the existing framework would likely result in an additional cost for market participants and would therefore need to be carefully weighed against the perceived incremental benefit.

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?

See response above.

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

Overall, members would like to take this opportunity to appreciate the work that the FCA has done by adopting a very pragmatic approach which has proven to be more effective than other jurisdictional approaches.

Nevertheless, members observed that the approach of the Stock Exchange of Hong Kong towards maintaining a list of "designated securities" provides a viable method as to the maintenance of a list of [overseas] securities subject to the SSR regime. As outlined under question 24, AFME is supportive of maintaining a "positive list" of shares that are subject to monitoring and reporting rules under the SSR.

Furthermore, members suggest enhancing automation in the context of reporting, similarly to the BaFin portal. Automation can ensure a smoother process and speed up the compliance with reporting requirements. For more details, please see our question 12.

2. Uncovered short selling

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

Overall, members consider the current restrictions appropriate, especially considering the market making exemptions, which are crucial to maintain efficient markets. Therefore, we recommend maintaining the current regulatory status.

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?

Overall, members believe that the current uncovered short selling restrictions are sufficient to reduce settlement risk. Such measures would be detrimental to the ability of market participants to engage in short selling activity. Short selling is a well-established investment activity, essential for market making and widely accepted by investors and regulators (e.g., IOSCO) as helping to enhance price discovery, counteract supply/demand imbalances, hedge other positions/exposures, and provide liquidity to the market in the relevant securities. We further note that short selling is typically part of a broader strategy that includes long positions.

Reducing the ability of market participants to conduct short selling, by imposing stricter locate requirements, could negatively impact market liquidity and efficiency.

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?

Generally, AFME members believe that current settlement discipline rules applied by CREST sufficiently incentivise market participants to avoid settlement failures. Indeed, the design of the CREST settlement discipline regime – whereby efficiency targets increase over time – effectively targets long-dated, persistent fails (such as those arising from an uncovered short.). Anecdotally, AFME members do not believe that short sales are a significant driver of settlement fails in UK markets. We encourage that any changes to rules governing the settlement process should be underpinned by detailed analysis of the root cause of settlement fails.

We note that there is a trade-off between optimising settlement efficiency and maintaining liquid, cost-efficient securities markets. In other words, measures to further penalise settlement fails are likely to inhibit the ability of market-makers to provide liquidity in securities which they do not hold in their inventory at point-of-execution.

3. Disclosure requirements – reporting to the FCA

10) Should the FCA specifically monitor short selling?

Yes, members agree that the FCA should monitor short selling for market integrity purposes.

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

Monitoring of adherence to the short selling regime is important in ensuring market integrity and confidence in the regulatory framework and enables regulators to identify more promptly emerging trends or behaviours (e.g., herding) that may become detrimental to the efficient and orderly functioning of those markets.

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?

Given the unique joint AFME/ISDA membership, many of our members benefit, either wholly or partially, from the market making exemption and as a result are generally exempt from these obligations.

Our asset manager members who are active in the UK securities markets report that they spend considerable resources tracking and reporting these positions to the FCA. The multiple reporting thresholds (0.1%, 0.2%. 0.3%. 0.4%, and 0.5%) and short turn-around time, together with the lack of a central share database to expeditiously and accurately calculate the percentages all add to the complexity and costs of such reporting.

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?

Members would prefer if the UK regime reverted to the 0.2% threshold to reduce the costs of reporting for market participants. Additionally, members recommend adjusting the disclosure deadline to end of day to make it more flexible for firms to wait for global system updates to be included in the disclosures. We support raising the threshold to 0.2% on the grounds this will reduce the volume of reports, and hence the overall reporting burden. However, this is on the basis that reporting would be relatively stable at this level. Making frequent and/or short notice changes adds cost and complexity to managing reporting, and hence if the FCA was minded having a power to require this threshold be reduced temporarily, for instance at times of particular market stress, then on balance we would prefer that they keep the threshold set permanently at the lower level of 0.1% The key concern for our members is that the level at which it is set, is not then frequently changed.

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

Members recommend that the new UK SSR allows for further automation in the context of reporting requirements, similarly to the function of the BaFin portal. Finally, our members would like to note that there is some degree of overlap between the SSR reporting requirements and the short-selling indicator included in the MiFIR transaction reporting form (RTS 22, Field 62) which requires firms to indicate whether the transaction is a short sale. On 13 January 2022, the FCA published its statement on supervisory flexibility on the short selling indicator whereby the FCA confirmed that it is considering policy options for the UK MiFID transaction reporting regime, including, among others, the future of the short selling indicator. Our members therefore recommend that the MiFIR short-selling indicator is removed.]

4. Public disclosure

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?

Short selling is a legitimate and useful activity which facilitates price discovery and enhances market liquidity. Some of our members are supportive of requirements to publicly disclose NSPs, noting that these disclosures are useful in the context of capital markets transaction and when advising issuers who want to raise capital. Others however, welcome amendments to the regime, such as anonymising of position holders' identity and the publication of NSPs on an aggregate level. This is in line with current practice in other jurisdictions (e.g., the US). If the requirements are amended to ensure that the identity of positions holders is anonymised, and the positions are aggregated, the FCA will continue to have full visibility of the market and short selling activities.

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

See previous question.

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

We are not responding to this question

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 needs to be disclosed and what would be the impact on your firm and the market from removing this?

We are not responding to this question

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?

Please see our response to question 15. In addition to this, we suggest that the periodicity of reporting requirements should also be reviewed so that it is meaningful. We would suggest that daily is impractical, but weekly or bi-weekly options should be considered.

5. Market Maker Exemption

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

While members would like to reiterate the importance of the market making exemption regime, they also note that it would be beneficial to soften the stock-by-stock application process, as it is unnecessarily time consuming. Specifically, members believe that the exemption should be considered solely on an activity basis.

Furthermore, AFME members believe that the short selling regime would benefits from the removal of the 30 days notification period ahead of its 'use' requirement, allowing market participants to use the exemption from the first day. Removing the 30-day notification 'ahead of its use' requirement would improve the efficient functioning of the market by formalising the FCA's current pragmatic approach, which is to automatically approve at the point of notification. This would streamline the process providing efficiency and certainty for market participants.

6. 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?

While members agree that the FCA should have powers to intervene in the market under exceptional circumstances, members view short selling bans as a last resort tool given their potential negative impact on markets.

Indeed, members would like to outline the challenges that short selling bans presented in the past, especially during the Covid 19 pandemic. Members observed adverse effects on liquidity, costs of trading and performance for those markets which were subject to short selling bans in 2020, along with higher volatility, while the bans did not achieve the intended outcome.

In April 2020, the World Federation of Exchanges (WFE) released an analysis[3] on the bans issued during Covid-19. In their analysis, they suggest that short-selling bans not only reduce liquidity, but also increase price inefficiency, hamper price discovery, and increased transaction costs. Additionally, they register unintended consequences on other markets as well, such as option markets.

By way of example, during the Covid-19-related bans, we observed a degradation in liquidity across the impacted markets. Members' analyses identified both lower volumes in markets subject to short selling bans, as well as somewhat higher volatility, along with higher costs of trading reflected in widened spreads, as compared to spreads prior to the imposition of the bans. Performance in markets which were subject to short selling restrictions, as proxied by a basket of market-cap weighted SXXP restricted names, also consistently under-performed the Stoxx600 from mid-March (whereas performance was in-line prior to the bans). This could be explained by fact that following the imposition of the short selling bans, a sub-set of market participants stopped or reduced their trading activity in restricted jurisdictions. Many firms pulled out of the market in the immediate days following the inception of the bans, particularly where there was a lack of clarity on the exact instrument scope of the ban. This reduced activity coincided with a rally in equities, and investors positioning for the rebound (i.e. increasing the long; short ratios), thereby acting as a headwind for banned markets to fully benefit and out-perform.

Finally, short selling bans carry further complications, such as the need for coordination across different jurisdictions. By way of example, market participants faced several challenges in identifying the perimeter of the ban issued by the CONSOB in terms of instruments which were in-scope. Specifically, market participants struggled to understand whether index derivatives traded on a trading venue outside of Italy would fall under the scope of the CONSOB's ban.

Should the FCA decide to issue a short selling ban in the case of market distress, we also recommend that they do so in a timely manner and that they provide the necessary clarity to the market on the scope of the ban. Additionally, we would recommend that the approach used for long-term bans are also incorporated in the short-term bans usage. [Noting that we have provided evidence which suggests that bans do not work and ideally should not be applied, we would recommend strengthening the safeguards that are currently in place for short-term bans. For example, the FCA could be required to confirm that a short term short-selling ban (Art 23 SSR) does not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits. Whilst we anticipate that this assessment and a level of cost benefit analysis would

[3] https://www.world-exchanges.org/storage/app/media/short_selling.pdf

already form part of the FCA's internal processes, the transparency of the confirmation would provide helpful clarity. The strengthening of the safeguards for the short-term ban in this way would be similar to part of the safeguard that currently applies to the long-term ban (Art 20(1) SSR).

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

See response to question 21.

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

Should the FCA issue short selling bans as last resort, members recommend ensuring that baskets, indices and ETFs are clearly out of scope. Indeed, given their cross-border nature and historical examples (see question 15), issuing bans which include those products can carry operational complexities because of the extra-territoriality implications.

In any event, to the extent that alternative measures are available, any decision to impose a short-selling ban should be justified by reference to such alternative measures considered by the FCA and the reasons why the FCA did not pursue such measures. Such an approach could be incorporated in the minimum content requirements of the FCA's notice under Article 25(2) SSR. Whilst we anticipate that this assessment and a level of cost benefit analysis would already form part of the FCA's internal processes, the transparency of the confirmation would provide helpful clarity.

7. 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?

Members support the change to a “positive” list of all shares since it has been proven difficult to assess all the shares that fall under the scope of the SSR in a timely manner. Nevertheless, to ensure efficiency and compliance with the reporting requirements, we recommend updating the list in a way that provides market participants with sufficient time to review it. Additionally, members recommend issuing the list with a machine-readable option so that firms’ compliance process can be automated, resulting in greater efficiency and lower risk of errors.

8. 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.

Some of our members consider that the current prohibition in SSR regime for sovereign CDS could be removed.

In their experience, the current restrictions on sovereign CDS have led to inefficiencies in markets for impacted products. As a consequence of the SSR, there are no natural holders of uncovered in-scope (UK) CDS. Without these restrictions, participants could use UK sovereign CDS as an effective hedge to cover various risks to which they are exposed to in the UK (not only holders of UK sovereign debt). By contrast, in markets outside of western Europe, investors can buy protection through CDS in countries without any short selling restrictions.

For example, an investor that would like protection on the Brazilian economy, or credit quality of Brazil relative to current market pricing, could buy CDS. If the CDS spreads widen, the investor is able sell the CDS to realise profits which would offset losses it may have incurred on Brazil. In the UK (as with other European sovereign CDS covered by EU SSR) it is not possible for market participants to buy uncovered UK sovereign CDS, other than in a market making capacity. Therefore, if UK sovereign CDS spreads widen, there are few market participants to dampen volatility by selling protection to those who require it. As a result, when markets start to widen, there are no market participants realizing profits and therefore swings in UK sovereign CDS prices are exacerbated. A good example of this was seen during Autumn 2022 –UK sovereign CDS moved from 15bp to 55bp in a little over a week and there was an absence of market participants selling protection to dampen the swing, as there were few owners of positions. By way of context, UK sovereign CDS usually trades in a 10-20bp range.

However, if HMT is not minded to remove the existing UK regime for sovereign CDS, we would urge HMT to simply retain the existing regime, rather than to make further amendments. This is because we do not believe that amendment short of removal of the regime would produce meaningful benefits for the market and believe that these would likely be outweighed by the costs and complexity of implementing additional changes.

In relation to SSR regime for sovereign debt, at this point in time members do not see the need for regulatory change.

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)

Changes to the UK SSR will inevitably result in requirements to update IT systems and amend operational procedures. However, on balance, those changes are welcomed if associated with additional benefits associated with a more efficient regime and where these benefits outweigh the costs of making such changes.

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