Discussion Paper

17

Financial Services Authority

Short selling

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1 Executive summary

1.1 Short selling – the sale of a security that the seller does not own – is a long standing market practice which generates periodic controversy. In the prevailing severe 'bear' market conditions, with very steep falls and high levels of price volatility both in markets and individual securities, complaints about the practice inevitably have increased. Suggestions have been made that short selling is harming market confidence and that measures are required to curb or constrain it.

1.2 Short selling was last the subject of regulatory review in the UK over five years ago, when the conclusion was that no specific controls were justified. Since then there have been considerable changes in financial markets, in terms of both trading mechanisms and trading strategies.

1.3 As part of our ongoing surveillance work on market practice and structure, we considered that it would be timely to look again at the issues raised by short selling. We are, therefore, publishing this paper to set out our thinking and invite views on the subject.

1.4 Short selling is primarily a professional activity. It is used by market makers and intermediaries to facilitate or hedge customer business; by hedge fund managers to establish principal positions as part of their investment strategies; and by investment banks, funds or individual market players wishing to take a view on the direction of a particular security or market. A short sale can be a complex and costly transaction, involving borrowing of securities in order to meet delivery obligations. In volatile market conditions in particular, it can also involve considerable risk to the seller if the market moves the wrong way.

1.5 Information on short selling is not collected, so it is difficult to know exactly how much is going on. However, based on a mixture of market intelligence and proxy data, we think that there has been no general upsurge in short

selling over the past few months. Indeed it appears that the trend in short selling by hedge funds may be down, although hedging strategies used by other market players frequently involve a short sale and may have an impact on market prices.

1.6 Our assessment of short selling remains that it is a legitimate investment activity which plays an important role in supporting efficient markets. It accelerates price corrections in overvalued securities, it supports derivatives trading and hedging activities and facilitates liquidity and trading opportunities. We therefore see no case for any prohibition on short selling, either generally or for particular stocks in times of market stress. Nor do we see any grounds for applying general constraints such as a Tobin-type tax on short sales.

1.7 However, we recognise that short selling can, whether directly or indirectly, pose a number of potential risks. These may include contributing to the potential for disorderly trading, generating increased short-term price volatility and being used in manipulative trading strategies. There are also potential settlement risks.

1.8 But we consider that present market and regulatory arrangements broadly address these risks and that the introduction of specific regulatory constraints would not be warranted. Nor are we convinced that restrictive measures used in some other jurisdictions are necessarily effective or appropriate for UK markets in that they neither appear to reduce share price volatility nor to soften market declines. We have found no clear evidence that short selling has played a significant role in the recent general market falls, although we would be interested to hear further views from market users on this.

1.9 However, we recognise that short sales are transactions that contain information that may be relevant to other market users. We consider that greater transparency for short selling may benefit market users and improve market confidence, not least by promoting greater knowledge of a part of the market which is relatively opaque and often misunderstood. But it is important that any disclosure regime must provide information which is useful to the market without being unduly burdensome to operate or breaching commercial confidentiality.

1.10 This paper sets out a number of ideas on the type of disclosure mechanisms which might be helpful to market users. These range from using data on securities lending as a proxy for short sales to the introduction of new reporting requirements for short sales in the cash equity markets or for all instruments which are used to take short positions. There are also some more targeted options for transparency initiatives. This paper seeks feedback on, in particular, the relative utility of different types of information, cost, market impact and feasibility.

1.11 The paper also notes that there has been the occasional problem involving settlement disruption for less liquid stocks in which there has been significant

short selling. It examines whether there may be a case for changes to tighten up certain settlement rules for such stocks.

1.12 Our work on short selling is taking place alongside work being conducted by the International Organisation of Securities Commissions (IOSCO) on the transparency of short selling. Currently, there is increased global attention on short selling as most major markets are in decline. IOSCO will issue conclusions sometime in 2003. In addition, we are a member of the Committee of European Securities Regulators (CESR), which may also touch upon short selling in the future in its ongoing discussions in relation to market developments.

1.13 We would welcome comments by 31 January 2003.

1.14 **This paper will be of limited direct interest to retail consumers since short selling is predominantly an activity used by market professionals and the options canvassed would primarily impact on market practitioners.**

2 Introduction

Background

2.1 The practice of short selling has long been a subject of considerable debate and differing views. Critics of short selling say that it increases share price volatility, exaggerates share price declines and forces the price of individual stocks down to levels which might not otherwise be reached. It is argued that, in extreme cases, it may depress the price of a security so much that it could create problems for the company in question, either by undermining commercial confidence and /or making fundraising more difficult. On the other hand, defenders of the practice see it as a necessary, indeed desirable, feature of the market that plays an important role both in providing liquidity and accelerating price corrections in over-valued stocks. Some believe that short sellers tend to stabilise prices in a declining market by covering their short sale positions often opened at the start of a downturn.

2.2 It is characteristic of 'bear' markets (and particularly highly volatile 'bear' markets) that they invariably revive public debate on short selling. This has happened in a number of countries, as well as in the UK. Here, concerns have been expressed publicly by several members of the institutional investment industry and by some issuers. In the international arena, we understand that several countries have also been reviewing their approach to short selling, although not necessarily with a view to tightening control. In addition, IOSCO is currently engaged on a project examining transparency in short selling.

2.3 The last UK review of short selling, undertaken in 1996/97 by the Securities and Investments Board ('SIB'), was triggered by the then government's proposals to liberalise the taxation regime for stock lending in UK equities. Following a public consultation, the SIB's core conclusion was that: 'short selling, which may increase as a result of wider access to stock borrowing,

should be controlled through general measures to prevent disorderly markets rather than specific limits on the ability to sell short.'[1]

2.4 The SIB review also concluded that it should consider further the practicalities of introducing some transparency to short selling and whether or not there was a case for applying controls to short selling in less liquid securities. In the event, the SIB decided not to proceed with any new proposals at that time.

2.5 There have been a number of significant developments in the market since the SIB review. Principal among these have been:

- the growth of investor interest in short selling and, more particularly, the significant growth in funds using short selling;
- the greater role and use of derivative instruments to create short positions (including, for example, contracts for difference ('CFD'), single stock futures and spread betting);
- the stock market 'bubble' of recent years and its subsequent puncturing;
- the change in the mechanism for trading (liquid) UK equities following the introduction and expansion of order book trading;
- the shortening of the settlement process;
- five years of liberalised stock borrowing;
- the increased availability of stock to borrow, as more long-term funds have entered stock lending as fund managers have looked for ways to generate incremental returns; and
- the development of equity repo.

2.6 In the light of these developments and our statutory objective to promote market confidence, we have decided that the time is right to review the role of short selling and revisit the regulatory conclusions reached five years ago.

Purpose and scope

2.7 This paper sets out to review how short selling is currently practised in UK equity markets, the role that it plays in the market, and issues of regulatory concern in the context of market confidence and investor protection. While we are keen to hear views on any aspects of short selling that give market users cause for concern, our initial thinking is that the areas where any improvements might most usefully be made are likely to relate mainly to transparency and possibly to settlement arrangements. We do not consider

1 The SIB published 'The Fiscal Liberalisation of Stock Borrowing and Repo in UK Equities: Regulatory Recommendations' in February 1997. This followed the Consultative Paper (100) 'Stock Borrowing and Short Selling: Implications for the UK Equity Markets', issued in November 1996.

that banning short selling or imposing constraints on its operation are either necessary or desirable.

2.8 While the focus of this paper is on equities (and on instruments which provide exposure to equities), we would also be interested in views on whether short selling in other asset classes – most obviously bond markets – raises issues that we should address.

Structure of the paper

2.9 In Chapter 3, we examine in more detail the practice of short selling with a focus on the characteristics of short selling, uses, trends and who uses the practice.

2.10 In Chapter 4, regulatory assessment, we consider the utility of short selling, potential risks, disorderly trading, market manipulation, conduct of business issues and finally the case for greater transparency.

2.11 In Chapter 5, we consider options for change to improve transparency and settlement.

2.12 Chapter 6 outlines the next steps after the publication of this paper.

3 Short selling in practice

Key characteristics of short sales

3.1 This chapter sets out a review of the current practice of short selling. It looks at the key characteristics of short selling and at the users of the practice. It reviews and gives examples of the uses of short selling and lists the alternatives to taking a short position in the cash equity markets. Finally, it discusses trends in the practice.

3.2 A short sale is not a legally defined term in the UK, nor is it a defined term in our Handbook. However, there is a general understanding in the marketplace that a short sale is a sale of a security that the seller does not own. The seller may have already borrowed the necessary securities on a temporary basis in order to deliver the stock to the buyer, or may not yet hold them at all – the latter situation is often referred to as a 'naked short'. It should also be noted that there are various derivative instruments that provide the ability to take a short position in a particular security or group of securities (e.g. an index), whether for hedging or speculative purposes. Use of these derivatives generally, though by no means in all cases, results in a short sale of the related cash securities further down the market chain in order to hedge the position.

3.3 Beyond this widely understood perception of a short sale as a sale of securities by a person who does not hold a long position, there is a limited understanding in some quarters of some of the key characteristics of a short sale. There is still a perception that short selling is a speculative free ride that drives prices lower. In order to address this misperception, it is worth mentioning three important aspects of short selling at the outset.

3.4 ***Short sales frequently involve a complex and costly transaction process.*** Unless a short position is closed out by a corresponding purchase before a delivery obligation is triggered, a short sale becomes a complex transaction. Essentially, it is not one but often four transactions:

- securities are sold short;
- the same number of securities are borrowed so that delivery can be made to the buyer;
- the same number of securities are purchased at some later date; and
- the purchased securities are returned to the lender.

3.5 The process for borrowing securities works broadly as follows. The borrower borrows securities from a lender by way of transfer of legal title (like a sale) and contracts to re-transfer an equivalent number of the same securities at some point in the future to the lender. The transaction needs to be structured in this way, both to enable the short seller to deliver full legal ownership, including voting rights, to the purchaser of the securities and to provide the lender with a perfected security interest[2] until the borrower returns the securities. Thus, a short seller has to put up collateral, either in cash or other acceptable securities, to at least the value of the securities borrowed.

3.6 ***Short selling involves considerable risk.*** Given that short sellers must at some point buy back an equivalent number of the same securities that were sold – either to meet their obligations to the purchaser, or to return the securities to the lender – they are exposed to the risk of the price of shorted securities rising rather than falling. In practice, that risk may be considerable if short sellers are caught in a 'bear squeeze'[3] or are otherwise unable to find securities to buy, making it difficult for them to close out their positions. Clearly, this risk is that much greater for those who take short positions in less liquid securities. A short seller also faces the risk that the borrowed securities may be recalled by the lender and it then may be difficult to locate more of the same stock. It must also be remembered that where long positions can offer potentially unlimited upside benefit, short positions have limited payoff potential in that share prices can go only to zero.

3.7 ***Profit does not always solely depend on a falling price.*** A short sale is often defined in an economic context as the sale of a security with a view to buying it back more cheaply in the future. That is often its economic purpose, but not always. As described in detail later in this chapter, there has been a considerable increase in recent years in the use of short selling in complex transactions that do not rely for their profit solely on the price of the shorted security falling. Profit in these transactions is generally dependent on the relative movement of two (or more) securities, or of securities and an index, not on the absolute direction of the price.

2 Perfected security interest means that the collateral is secure and legally belongs to the person holding it.

3 'Bear squeeze' or short squeeze occurs during a period of sharply rising prices caused by professional shorts covering their positions. The high prices force the short sellers to cover their shorts and realise losses.

Alternatives to the short selling of equities

3.8 There are a number of alternatives to taking a short position (short sale) in the securities themselves:

- put options (whether traded on-exchange or over-the-counter);
- single stock futures traded on LIFFE;
- FTSE index futures and options;
- CFDs based on an equity index or on a particular security;
- total return swaps[4]; and
- spread bets (again either on an index or on a particular security).

3.9 As noted elsewhere, many of these 'alternatives' still lead to a short sale in the cash equities market when risk management calls for a hedge.

Uses of short selling

3.10 As noted above, short selling is generally associated with transactions designed to realise profit from a fall in the value of the asset sold. This remains a core use of short sales. But the ability to go short has been a fundamental characteristic of the UK market making system for many years. This also has more to do with liquidity provision than with directional views on price. More recently, there has also been increased use of a wide range of strategies in which short selling plays an integral role or leads to short sales as part of the hedging process. But with the development of the CFD and the over-the-counter options markets, a short sale may be the hedge to one of these transactions rather than an investment strategy in itself.

3.11 In *Figure 1* we set out a couple of examples of short selling in today's markets, including its use in conjunction with derivatives transactions.

Figure 1

Examples of types of short positions

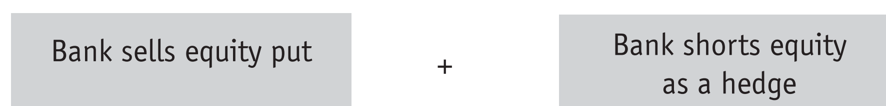
Long/short equity strategy

Long undervalued equities + Short overvalued equities

4 A total return swap is an agreement between two counterparties to exchange cash flows – one of which might be the total return on the FTSE 100 index and the other (which will replicate the cost of funding) might be either a floating interest rate plus or minus a spread, or the total return on another equity index plus or minus a spread.

In this example, a fund manager goes long a group of equities that he perceives to be undervalued and short sells another group of equities that he considers to be overvalued. In this strategy, the fund manager does not necessarily need the price of the shorted securities to fall to yield a profit. The profit comes from the relative performance of the long and short securities: the long position must outperform the short position, regardless of the absolute direction of the prices.

Short equity as a hedge



In this example, a fund manager buys an equity put in the over-the-counter options market on a sizeable portfolio of equities, from an investment bank, to protect itself in the event of future falls in the prices of these securities. The investment bank hedges its own exposure to any exercise of the put option by short selling the equities underlying the option.

Users of short selling

3.12 Short selling is largely the domain of principal intermediaries (including market makers, e.g. investment banks), hedge funds and speculative investors. It is essentially an investment tool used by professionals. (However, we see evidence of increased retail appetite for investment involving the use of short positions, whether through managed funds or directly using a variety of derivative products, in particular spread betting and CFDs.)

3.13 Market making and intermediary liquidity provision has traditionally played a central part in the UK market structure. Market makers are committed to guaranteeing two-way prices. In doing so, they add to market liquidity and two-way price formation. As such, they need to be able to short sell securities in order to fill customer orders. They enable customers to take short positions and in doing so the market maker needs to hedge its own position, which it may cover by selling the underlying equity short. Some jurisdictions drop any short selling rules in the case of market makers, in order to reduce the impact on market liquidity.

3.14 Additionally, market makers may take their own directional views on markets by short selling cash equities, selling index or single stock futures or creating a short position through a CFD.

3.15 Hedge funds themselves will take short positions, but usually in combination with a long position in another stock where they seek to profit from the relative move in prices between the long and the short positions. When the short position is taken through their prime broker (investment bank), the hedge fund may then also borrow the stock from the same source to satisfy

the delivery to the buyer on the other side of the short transaction. In turn, the prime broker may either borrow the stock from the market or it may have the stock in its own inventory, either from its in-house principal trading desk or from its fund management arm.

3.16 Speculative individual investors also take short positions in equities. These investors generally take a directional view on a security either by short selling the equity, or increasingly by buying a put option or selling a CFD or a spread bet. Some of these investors can take sizeable positions. Less is known about these individual investors and their motivations because they tend to set up short positions in off-exchange products with less transparency such as CFDs and spread bets, rather than selling the equity itself.

Trends in short selling

3.17 An obvious difficulty when neither we nor the equity exchanges require the identification of short sales is to know exactly how much short selling is taking place. In order to get a view of the extent of short selling in a particular sector or in a security, we rely on a mixture of market intelligence and data that may give some indication of the extent of short selling activity. The latter includes, for instance, trends in derivative activity, but the data here is incomplete and the extent of cash market hedging largely unknown. It also includes trends in stock borrowing, but this too is an imprecise proxy in that stock borrowing is frequently used for activities other than settling short positions (see Annex A, paragraph 3).

3.18 Most market participants whom we have spoken to say that overall short positions by hedge funds are lower than they were when the equity markets were appreciating and price volatilities were lower. With historically high levels of price volatility, and the possibility of a bottoming out of the 'bear' market, many fund managers consider short positions are even riskier than normal. Long/short funds are said to have reduced their overall long positions and increased their short positions, but the latter only incrementally. There were spikes in the level of short selling in June, when the markets were at their most volatile, but these spikes were very short lived.

3.19 From the evidence presented to us, it would appear that the trend in short selling by hedge funds appears to be down and is expected to remain so until overall market volatility returns to more normal levels. However, long positions have also been reduced. As noted above, hedge funds are not the only users of short sales. Currently, short positions in equities and equity derivatives are being used as hedges by the investment banks, offering large equity risk management strategies to pension funds and life insurance companies. These hedges are notable for their size and may have an impact on market prices.

3.20 A few concerns have been expressed that intra-day short selling may be having an impact on market prices. Feedback thus far suggests that there is not a significant amount of intra-day short selling occurring in UK markets, but this is particularly difficult to assess for the market as a whole as these positions are closed out the same day.

3.21 We have noted that when liquidity drops off in declining markets, the impact of short selling appears to have a greater impact on the market because of the lower level of participation of long term investors.

Q1: Do you agree with this assessment? If not, what is your assessment of recent trends in short selling?

4 Regulatory assessment

Overview

4.1 This chapter first sets out why we consider short selling to be a legitimate investment strategy that can contribute to market efficiency and why we remain of the view that a ban or the imposition of specific regulatory constraints on the practice are not warranted. It then identifies some of the potential risks associated with short selling and explains why we consider that the current regulatory framework adequately addresses them. Finally, it outlines two areas where we consider improvements on the present situation, particularly as regards improved disclosure, would be worth pursuing.

4.2 At present, the UK has no regulation designed specifically to restrict short selling or to control the process of short selling. Instead, short selling, like other forms of securities markets activity, takes place within the general framework of rules on customer suitability, prudential safeguards, orderly markets, fair trading practices and efficient settlement that apply to trading. This has been considered sufficient to address the risks that may arise with the practice.

The utility of short selling

4.3 The principal argument in favour of allowing short selling has traditionally been the benefit it can bring to the market in accelerating price corrections in overvalued securities or to accommodate abnormal buying pressure which would otherwise overinflate a security's price. We consider this argument remains a valid one. Indeed, this function may be even more important in a market increasingly dominated by large, longer-term investors and index funds. The former are often reluctant to make substantial changes to their core holdings through 'bull' and 'bear cycles', while the latter seek only to maintain a correctly weighted portfolio (to optimise index-tracking accuracy) and have no interest in the fundamental strengths or weaknesses of an index's underlying components.

4.4 Similarly, short selling also benefits the market as a support for trading that corrects pricing anomalies. Without the opportunity for arbitrageurs to lock in a profit by going short of the 'overvalued' instrument at the same time as going long of the 'undervalued' instrument, the efficiency of the price correcting process is correspondingly greatly reduced.

4.5 A third, more practical, benefit of short selling has been that market making and intermediary liquidity provision has traditionally played a central part in the UK market structure. Any attempt to restrict the freedom of liquidity providers to go short would, in effect, have made that role impossible. Applied in full, it would, for example, have prevented market makers satisfying customer buy orders except out of inventory.

4.6 Similarly, any effective restriction on cash market hedging through short sales would potentially increase the costs of risk management and would seriously constrain the use of derivatives. The efficient working of the market in 'downside protection', whether through the use of put options, CFDs, or equivalent instruments, depends on the ability of the sellers of the protection to hedge their exposures by opening a matching short position elsewhere, often in the underlying cash securities.

4.7 In facilitating all the above trading strategies, short selling adds to pricing efficiency by bringing additional trading opportunities and liquidity to the market in general. Hence we see no case for prohibiting short selling – indeed no major financial market does so – nor for introducing constraints for the purpose of deterring use of the practice.

Potential risks

4.8 While we view short selling as a legitimate investment strategy that brings significant benefits to a market, we recognise that it may also bring some potential risks. This is why a number of countries consider it necessary, in their specific environment and circumstances, to impose various controls on short selling.

4.9 In broad terms, these risks are as follows. First, there is a set of market risks that arise from the way in which short sales add weight to the supply of long sale orders in the market. This does not automatically lead to disorderly or manipulative trading, but may increase the potential for both. Short selling may also increase short-term volatility in share prices. A further market risk may arise from any settlement disruption for 'naked' shorts and any consequent failure to deliver. Second, there are potential risks within the chain of the short selling process. These relate to the settlement process and efficient risk management in the operation of the securities lending market.

Disorderly trading

4.10 The potential risk of disorderly trading arises, for example, essentially from the incremental weight of sell orders generated by short sales overwhelming current buy-side interest and causing an accelerated fall in a share's price and an increase in price volatility in the short term. The particular concern here is that this can happen very quickly, leaving little or no time for potential buyers to assess the new position and take action that might otherwise stabilise the price and dampen volatility.

4.11 A number of foreign jurisdictions address this specific issue through the use of 'tick' rules. These operate in slightly different ways, but their basic purpose is to prevent a short sale being made at a price below the last traded price. This aims to reduce the speed of a downtrend by preventing short sellers using sequential trades to clear current buying interest at progressively lower prices[5].

4.12 UK Exchanges providing trading in equities have not adopted tick rules. In the past, this reflected the UK Exchanges' general assessment that controls on short selling were unnecessary in what was then a quote driven market operated by market makers. But nor have the equity exchanges changed their position following the introduction and expansion of order book trading. This mainly reflects the fact that, rather than focus on any price volatility caused by short selling per se, they have instead introduced more general rules and processes to safeguard against excessive price volatility. The LSE provides for an automatic trading halt in SETS securities where the price of the next trade would execute at 5% or more away from the previous trade. virt-x have the same rule for their UK securities.

4.13 We are inclined to the view that that this is an appropriate approach to dealing with excessive short-term price volatility. We also have some concerns about 'tick' rules, particularly about the potential complexity of creating exemptions to those rules, since short selling rules may require exemptions for certain market participants. Even more importantly, we have not seen a strong case showing that tick rules curb share price volatility or soften market declines. For example, at least as far as this year is concerned, countries operating tick rules, such as the US, have not seen less steep market falls or significantly reduced volatility than the UK.

Q2: Do you believe that the approach taken by the UK Exchanges and the FSA is the correct approach? Do you consider that present processes sufficiently address price volatility?

5 Tick rules provide that a short sale can only take place if the previous price movement in a stock was an upward one (an 'uptick' rule such as operated in the US) or a flat one ('zero' tick rule).

Market manipulation

4.14 There is still a strong perception in some quarters that short selling is an essentially manipulative activity, used largely to drive down prices. However, as described earlier, a significant part of short selling in today's markets is driven by a variety of trading strategies that have nothing to do with what is commonly known as the 'bear raid'[6].

4.15 Our view is that short selling is not in itself manipulative. Rather, we see it as a valid investment practice that, in essence, represents the opposite of taking a long position. However, short selling, like any other form of trading, may be manipulative when misused. Where it occurs in relation to any investment traded on a UK Recognised Investment Exchange or OFEX, abusive short selling, just like any other form of market abuse, is caught under the market abuse regime and the Code of Market Conduct[7].

4.16 Short selling undertaken, whether or not in collusion with other short sellers, for the purpose of positioning the price of a security at a distorted level would amount to market abuse. For example, if an investor, or a group of investors, holds a short position in a particular security and then circulates false or misleading information, e.g. possibly in the form of a rumour, about the issuer of that security to depress the price of the security in order to profit from the short position, he would likely be in breach of the market abuse regime. This regime carries unlimited fines.

4.17 We therefore consider that the present regime provides sufficient tools for dealing with abusive short selling and, where we have hard evidence of market abuse, we will be prepared to investigate.

Settlement risks

4.18 A major concern in many countries is that short sellers may fail to deliver the securities they have sold, causing settlement disruption. Concerns that 'naked' short sellers may be encouraged by loose settlement disciplines has led a number of countries to set certain requirements. For example, they may require that short sellers borrow securities ahead of the sale or have arrangements in place that will enable them to make delivery of the securities.

4.19 As far as the UK is concerned, both Recognised Investment Exchanges and Recognised Clearing Houses are required to have satisfactory arrangements to secure the timely discharge of the rights and liabilities of the parties to transactions. In practice, this means that they have rules[8] on settlement which ensure that it is orderly and timely and that rights to benefits (for example,

6 'Bear raid' takes place when a group of investors sell short large quantities of a security to position the price of the security at a lower level and then buy the security back at the lower price, profiting from the difference.

7 See the Financial Services and Markets Act 2000, Part VIII section 118 (Market abuse).

8 See Annex B: Settlement discipline rules

dividends) are protected throughout the settlement process. These rules also impose penalties in some instances for frequent non-delivery, and provide for buying-in the securities in question when delivery is delayed. Overall settlement performance in the UK is good and where settlement failures do occur the Recognised Investment Exchanges and Recognised Clearing Houses have arrangements to deal with them.

4.20 In addition, the risk control requirements placed on firms by us to provide for the proper management of exposures means that they should make appropriate arrangements for securities lending and borrowing to minimise credit, legal, and operational risk. In this area, the industry also has its own well-established and widely accepted codes of best practice.

4.21 However, the risk of settlement disruption cannot be ruled out entirely, particularly for less liquid stocks. In a notable case last year, there was short selling in the shares of a company to such an extent that the short sales outstripped the shares in issuance. The result was that many purchasers did not get delivery of their shares and were unable to vote at an EGM. While such occasions may be very infrequent, it is considered that ensuring more robust settlement procedures may help in reducing the risks of a repetition. Chapter 5 sets out ideas for achieving this.

Investor protection/ Conduct of business (COB) rules

4.22 As noted above, short selling is essentially a professional activity. However, firms that do sell short on behalf of private customers will, of course, be subject to COB rules that apply to all firms conducting designated investment business.

4.23 COB 1.6.2 R sets out the COB specific rules that apply to stock lending activity undertaken by a firm with, or for, a customer. COB 9 (Client assets) also contains specific provisions on stock lending activity. Other COB rules will apply as appropriate.

Q3: Do you have any comments on the conduct of business regime, as it currently applies to short selling and stock lending activity? Could the regime be improved in any way?

Case for greater transparency

4.24 Although we are currently not convinced that market confidence would benefit from direct controls on short selling, we recognise that short selling is a matter of concern to some issuers and market users. This concern appears to derive, at least in part, from the opacity that surrounds short sales. Some argue that short sales may contain potentially important information which, if public, would tend to enable other market users to make better informed investment decisions.

4.25 In general, we support disclosure, seeing it as a key factor in facilitating efficient markets. We are aware that some market participants have information on short positions and stock borrowing figures, while others do not, leaving those with the information in a privileged position.

4.26 Our view is that short sales do contain information of value to other market users. While we accept that the motivation behind short sales varies, many sales (other than pure arbitrage sales) do in some respects reflect a view that a security is intrinsically overvalued, even when that view is based more on relative than absolute over-valuation. It also recognises that the fact that a short sale must, by definition, lead to a purchase of an equivalent number of the same securities makes it technically different from other transactions in a way that may be of material significance to other market users' investment decisions.

4.27 However, we are very aware that mandated disclosure needs to be useful and that its benefits should outweigh any disadvantages. On this point, there may be strong limitations on what is achieved by greater transparency on a cost-benefit basis. This is discussed in Chapter 5.

5 Options for change

5.1 In this section, we set out a number of possible options for improving transparency on the scale of short selling, focusing in particular on the potential scope for information to be disclosed. We then consider what might be done to improve settlement performance for less liquid securities.

Transparency

5.2 In assessing options for improved transparency, we seek respondents' views when considering the options. We propose to use the following framework:

i) The information made available should be of a kind that is most useful to the market and as up-to-date as possible, recognising that production of real time data may not be feasible.

ii) The information gathering arrangements should be enforceable and not overly burdensome for market practitioners and infrastructure providers to operate. The arrangements should be applicable in 'bull' as well as 'bear' markets and should not be designed with only 'worst case' market conditions in mind. They will need to meet the cost benefit and proportionality tests.

iii) The arrangements should not involve unwarranted breach of commercial confidentiality. Excessive disclosure runs the risk of deterring short selling, which would thereby deprive the market of the benefits which short selling brings. Knowledge of individual market participants' and market makers' short positions could jeopardise their trading strategies and expose them to increased risk of being caught in a 'bear squeeze'. Hence, information needs to be on a suitably aggregated and anonymous basis.

5.3 There is inevitably a trade-off between the comprehensiveness and precision of the information sought and how costly and burdensome it would be to collect. All the options discussed below need to be considered under these constraints.

Q4: Are there any criteria regarding the information on short selling that we have missed and that we ought to consider?

Option 1 Marking and reporting short sales for cash equities

5.4 This option would entail requiring all market participants to mark each short sale trade they make in the cash equity markets and regularly report their aggregate short sale positions to the Exchanges and to the FSA. This information would then be published on a regular basis. This option would apply only to the cash equity markets and thus would not include short positions in derivative instruments such as CFDs, total return swaps and spread bets.

5.5 This is the approach taken in several other jurisdictions. The benefit is that the market can see the extent of aggregate short selling in any particular security and draw its own conclusions from that information. Companies would also be able to see the extent of short selling in their own stock. However, the counterparties to the short sales would not be disclosed.

5.6 The issues that would need to be considered are:

i) *Defining a short sale:* we would need to define what we mean by short sale – would we capture short sales that involve a borrowing or just short sales which are not covered with a borrowed security (e.g. 'naked' short sales)?

ii) *Utility:* We need to determine who would use the information and how they would use it. How useful would the information be in the absence of publishing data on the use of derivative instruments for short positions? Would market participants move to use other instruments for effecting short positions if we single out only cash equities for marking and reporting?

iii) *Timeliness:* To be useful, the information would have to be disclosed on a timely basis. We understand from market participants that monthly figures (as published in the U.S.) are too out of date. Some participants have told us that they would like to see figures published on a daily basis, but this might raise a feasibility issue.

iv) *Cost:* This system would inevitably involve extra costs and is likely to be an expensive requirement. Firms engaging in short selling would need to invest in systems to track short sales and need to be able to identify short selling activity on two different equity exchanges (London Stock Exchange and virt-x). It would mean changes in the systems for the central counterparty as well as at the Exchanges. We have not carried out a cost-benefit analysis of this approach, so we are very interested in hearing your views on particular cost implications.

v) *Commercial confidentiality:* Would such a system make short sellers more susceptible to squeezes? Would market makers need to be exempt? Should there be a similar exemption for hedging using short sales?

Q5: Would this approach be desirable and why? How would the information be used and by whom? How often should the information be disclosed? What are your thoughts on the costs of this approach? Would this approach lead to more short selling being transacted in the derivatives markets?

Q6: Would certain market participants be disadvantaged by daily disclosures if the information were disclosed per security even if counterparties were not identified?

Option 2: Full disclosure of short positions in both cash and derivatives markets

5.7 We understand that a substantial proportion of short positions occurs in relation to the equity derivatives markets, particularly in CFDs. These are not subject to any stamp duty and so are the instrument of choice for many market participants, including hedge funds. Another option would therefore be to require all short position transactions whether in derivatives or in the cash equity markets to be marked and reported. This would give a fuller picture of the extent of short positions. Some of this information is already collected. For exchange-traded derivatives, the exchanges publish data on index and single stock futures as well as equity options, although this may mask the extent of offsetting positions. However, data on over-the-counter derivatives, such as CFDs, spread bets and equity swaps and options, is not currently collected or published.

5.8 This option raises some similar issues to reporting short sales in the cash equity markets but would inevitably be more costly and complicated.

i) *What would be captured?* There would be definitional problems to sort out in determining what the reporting requirements would cover. Would such a regime capture, for example, shorting the FTSE index; short selling an American Depositary Receipt; short selling one stock and going long several others as a long/short strategy; shorting a CFD or spread bet position; or structured trades involving a short position?

ii) *Cost Benefit:* such an approach would inevitably seem to involve very significant costs in terms of systems to identify and aggregate positions across global books in various locations. Again, this would also have systems implications for the Exchanges and for the central counterparty. Since the bulk of derivative short positions are ultimately hedged in the cash equities markets through short sales, would this option add significant benefit to what would be gained by reporting cash equity short sales under Option 2, or even information represented in the stock borrowing figures under Option 1?

iii) *Feasibility:* would such a comprehensive reporting system be feasible, particularly for international companies operating out of multiple centres with global trading books which get passed from centre to centre for 24 hour coverage? Would this approach cause market participants to

transact away from the Exchanges in alternative products or in alternative financial centres, thereby defeating its purpose?

Q7: Would you consider it necessary to capture all short positions in all derivatives markets, including the non-exchange market (over-the-counter market)? How would the information about derivative short positions be useful? What feedback can you give us on the possible cost implications?

Q8: Can you suggest any other options as regards general transparency of short positions?

Option 3 Data on securities lending as a proxy for short selling

5.9 One option would be to rely on market-led developments in the securities lending marketplace that may result in increased transparency of stock borrowing, and thus provide a proxy for short selling activity.

5.10 As explained in Chapter 3, typically a short sale needs to be matched at some point in the future by a purchase of stock to cover the short position. Before that purchase, stock is usually borrowed to deliver to the purchaser on the other side of the short sale. Knowledge of the level of stock borrowing which occurs at any point in time could be helpful in providing a clearer picture of the pressure on the supply of particular stocks and perhaps on the level of short selling occurring. The data may also assist the operation of the securities lending market – by giving lenders a fuller picture of short-term developments as well as enabling them to determine their share of the market.

5.11 CRESTCo already has the capability to produce data on stock borrowing both on an aggregate and per stock basis. It currently publishes monthly aggregate figures. However, in its raw form this data involves considerable double counting because of the significant involvement of intermediation in this market. As such, there is a question mark over how useful the data would be to the market.

5.12 However, CRESTCo is now working with a third party information provider on a service to produce more refined stock borrowing figures on a per security basis for liquid securities. The intention is to strip out double counting of lending transactions as far as possible. The service would be made available on a subscription basis to the market, with users able to access analysis of borrowing figures for individual stocks and sectors. In addition, it is possible that certain high level data might be published for wider distribution.

5.13 If such refined data could be successfully produced, it would act as a more accurate indicator of the extent of borrowing in the most liquid stocks. The information would not require the introduction of any new reporting requirements and therefore would not impose additional burdens on market practitioners or market infrastructure providers. As such, it would appear to

meet the cost test (even though those who wanted to access the information would need to purchase it). Nor would it appear to raise concerns about commercial confidentiality, given the intention to limit the scheme to liquid stocks where individual positions cannot be identified.

5.14 However, given that stock lending occurs for reasons other than covering short sales (e.g. collateral movement, dividend transfers, hedging or arbitrage), it will never be a perfect proxy for short selling. The question is whether it would nevertheless provide a rough and ready proxy of use to the market.

Q9: Do you believe that the public availability of more accurate stock borrowing figures would provide a better picture of the extent of possible short selling activity? Given that it will be a rough and ready proxy, are there significant risks that the data may be misleading – especially for less sophisticated market participants?

More targeted transparency options

5.15 There are also some options for more specific disclosures that might be pursued either with or independent of any general transparency measures.

Option 4: Disclosure of short sales beyond a certain threshold – Short disclosure to issuers

5.16 Currently the Companies Act 1985 requires persons with interests of 3% or more of any class of a company's voting shares to notify that interest (and subsequent changes) to the company. UK Listing Rules require that issuers should then publish such notifications to the market. Some market participants have suggested that parallel reporting of short positions would give investors, lenders and issuers a better understanding of who was taking large short positions. To reveal the ultimate holder of the short position, the notification arrangements would need (as with long positions) to capture at least some element of the short position represented by derivative positions, for example, equity put options. It should be remembered that if a party borrows 3% or more of a company's shares, then they are required under the Companies Act to report that interest to the company.

5.17 It is worth noting that the Companies Act disclosure requirement is driven by the management's need to know where the control over a company's shares lies, rather than by investor or market considerations. In addition, short positions are different to long positions in that they do not pay dividends, do not confer voting rights, have limited pay off potential and are subject to squeezes on the availability of cash equities to close those positions. Thus, they are considered to have different risk and pay off profiles to long positions. As such, disclosing short positions may put the short position holders at risk, particularly as they represent a very small percentage of overall market positions. Nonetheless, it has been suggested to us that

company management needs to be able to communicate with holders of large short as well as large long positions, and that market users as a whole would benefit from knowledge of large short positions.

5.18 The Companies Act 1985 is not within the FSA's scope of responsibilities and, if this option were considered worth pursuing, detailed consideration would need to follow, particularly as to the method of disclosure.

Q10: Do you consider that a market disclosure of short positions is warranted ?

Option 5: Disclosure of short sales in specific situations

5.19 We understand that there is some concern about 'naked' short selling and the extent to which it may cause settlement disruption to shareholders. To address this concern, one option may be to require disclosure of all 'naked' short positions in cash equities, which might have the effect of limiting 'naked' short positions. To ensure commercial confidentiality, the party to the short sale would not be disclosed but aggregate 'naked' short positions in individual securities would be. This option would inevitably involve extra costs to both the relevant Exchange and to the holders of the 'naked' short positions.

Q11: Do you think that 'naked' short sales should be disclosed to the market? How would you use that information? Would any market participants be disadvantaged by such a disclosure?

Option 6: Directors' dealings in short sales

5.20 Another measure would be to ensure that directors are required to disclose all short positions they take (both cash equities and derivatives) in the stock of the firms on whose boards they sit. Companies are required to notify the market of transactions by directors that give rise to 'interests' or cessation of interests in the company. There is no judicial precedent on the interpretation of this provision and whether disclosure of the short aspect of these sales is required. However, there is a clear argument that they are required to be disclosed. In practice, directors' dealings are unlikely to represent a significant proportion of all short selling and there are already measures in place which tend to limit this practice by discouraging speculative trading by directors. Nevertheless, it has been suggested that it may be worthwhile removing any loophole that may exist currently.

Q12: Do you consider that this option should be followed up?

Settlement

5.21 In this section, we set out one suggestion for improving the settlement and delivery of equities, as short selling in less liquid securities may be of concern if the settlement process is not robust enough.

5.22 UK exchanges do not have particular rules on short selling. However, they do have settlement rules that aid the efficient settlement and delivery of securities. Typically, the Exchanges use settlement discipline rules to deal with delayed settlement. One of these disciplines undertaken by the Exchanges is to buy-in the securities in question for delivery to the purchaser if delivery was not made within a limited period after the Intended Settlement Date. Usually the purchasing firm submits to the Exchange a request that the outstanding shares are bought-in against the selling firm. The timeframes for requesting buy-in and for actual buy-in vary according to the liquidity of the securities in question. For less liquid securities these timeframes tend to be longer because the securities may not be readily available. These timeframes are currently being reviewed and may be shortened in order to reduce unnecessary delivery disruptions, particularly where voting rights at an AGM or EGM are concerned.

5.23 Another possible option is to consider whether guaranteed delivery[9] should be required for all short sales. This would help avert problems experienced in the past where short selling outstrips the available supply of shares – possibly causing problems for shareholders who may be relying on delivery of those shares to them for voting purposes – and ensure that the short sold securities can be located for delivery.

Q13: Do you consider that shortening the timeframe would help avoid settlement disruption in less liquid securities? Are there other suggestions on settlement and delivery, particularly for short sales, which you believe would be beneficial?

Q14: Do you think all short sales should be transacted with guaranteed delivery? (See Annex B, paragraph 6.)

9 See Annex B: Settlement discipline rules, paragraph 6.

6 Conclusions and next steps

6.1 Comments on the issues raised in this paper are invited no later than 31 January 2003. Following consideration of those responses, we will issue a Feedback Statement summarising the main points made by respondents and indicating what further action we intend to take. Any detailed proposals for changes we should decide to pursue in the light of the responses to this paper would, of course, be the subject of a further consultation exercise.

6.2 We would anticipate that a Feedback Statement would be published sometime in the late Spring 2003.

Links to the securities lending market

1 To cover a short position in a security, the short seller must borrow the security from the market or source the security from its own inventory. The securities lending market is made up of borrowers, lenders and intermediaries. Securities lending transactions are typically privately negotiated transactions outside a central trading floor or central electronic trading system. The borrowers are, not surprisingly, overwhelmingly the investment banks who are active in both domestic and global financial markets. The lenders are pension funds, insurance companies and fund management companies. These firms lend out their portfolios to maximise return on their assets.

2 The intermediaries in the securities lending market provide access to stock, CFDs, swaps and other derivatives as well as operational and administrative support. Most institutional investors do not lend on a scale large enough to support their own securities lending business and so rely on the services of a custodian which offers securities lending management services. Smaller funds also look to custodians for overseas access to borrowers and lenders. Some of the large broker-dealers (i.e. investment banks/prime brokers) play several roles, that of borrower, lender, market making intermediary and supplier of administrative services.

3 Firms borrow securities for a variety of reasons, for example: 1) when they have sold securities which they have purchased but not yet received; 2) when they need to deliver securities against the exercise of a call option; 3) when they have sold a security short either to open a position or to fulfil a customer order by the market maker; 4) when they need to purchase collateral for positions currently held or for another securities lending transaction; or 5) when they need to cover a settlement failure.

4 Firms may borrow securities as part of an arbitrage transaction (see paragraph 3, point 3, above) in which they can profit by taking advantage of a pricing differential between two investments which should have similar if not the same value. Some common forms of arbitrage which utilise the

borrowing of securities are: 1) convertible bond arbitrage in which the holder of the bond synthetically is long the equity and so in order to hedge that long position short sells the equity on the market; 2) index arbitrage in which the investor can take advantage of pricing differences between the cash equity market and the index futures market by borrowing securities, selling them, investing the proceeds at the current interest rate, and then buying back the securities by taking a long index futures position (used by large index tracker funds); 3) dividend arbitrage in which tax treatment for local residents differs to that for foreign residents over a record date. Here the local resident can borrow the securities over the record date, earn the dividends, and pay back only a portion of those to the lender; 4) merger arbitrage in which two companies involved in a one for one share merger trade at different prices. Investors holding the target company's shares may borrow the shares of the offeror and sell them locking in a positive spread.

5 Most of the arbitrage opportunities identified above have all but disappeared, leaving fewer investment opportunities for funds.

Annex B

Settlement discipline rules

London Stock Exchange (LSE)

1 The LSE does not handle the settlement of securities traded on its exchange since CREST assumes that role. However, the LSE does handle settlement discipline for which it has a number of rules and procedures.

Buyer protection

2 The LSE has detailed rules on the treatment of buyer's rights which create obligations on the seller to protect the buyer's economic entitlements. These rules are of particular importance in protecting the buyer's interests arising from transactions that occur at or near the time of a corporate action.

Buying-in rules

3 These rules apply to all equity transactions regardless of where they settle. If settlement has not occurred by the Intended Settlement Date ("ISD" – usually T+3 but can be anything up to T+25), the buying member firm may notify the LSE and request that the LSE serve a buying-in notice on the counterparty. The LSE rules state that buying-in requests may be submitted 5 business days after the ISD for Order Book securities (ISD+5), ISD+10 for non order book FTSE 250 securities and ISD+90 for all other securities. Buying-in will then take place 6 business days after the buy-in request is received (for example, although rare, ISD+90 could result in settlement occurring on T+121). The longer periods before buying-in may take place in securities outside the FTSE 100 and 250, which are generally less liquid, allows additional time for settlement to be resolved before the Exchange intervenes. However, where a transaction is undertaken for guaranteed delivery (see below) in any security, the buying-in request may be submitted on ISD+1 with buying-in taking place immediately.

4 While there are more than one million bargains on Exchange every week, there are very few buying-in requests by member firms. Only a fraction of the requests proceed to buying-in, generally because the securities are delivered after the counterparty is informed that buying-in will occur and before the

buying-in actually taking place. There may also be circumstances where the buyer's interest is otherwise protected under the buyer's protection rules and the buyer chooses not to proceed. The party that has failed to deliver bears the costs of the buying-in by the LSE.

5 The LSE charge £25 to the firm on which they serve a buying-in notice. They will then charge a dealing fee of a minimum of £30 for sterling transactions and $50 for USD transactions and euros 45 for European transactions. The actual charge is a percentage of the transaction value. There is a subsequent penalty of £20 for each day the buying-in transaction remains unmatched, and an additional funding fee of 4% over the base rate for each day the buying-in transaction remains unsettled past its ISD.

Guaranteed delivery

6 The LSE offers the ability to trade for guaranteed delivery where the buyer has determined that the security is readily available at the time of trading. Trades undertaken for guaranteed delivery are subject to an accelerated buying-in timetable (see above). Guaranteed delivery may be used if there is a need to appear on the share register by a certain date. There is no LSE charge for guaranteed delivery. Very few trades are undertaken for guaranteed delivery, which would suggest that investors rarely ask for this assurance.

Mandatory settlement & Pent up demand disclosure

7 These rules provide additional visibility to open settlement positions and increased confidence in timely settlement in periods of particular price sensitivity. These rules are typically used ahead of secondary new issues. The company and its advisors would ask the LSE to invoke the mandatory settlement rules to apply when they know that there will be a delay of several weeks between the announcement of a secondary new issue and the pricing of that issue. The purpose of these rules is to provide a degree of price stability during that period by limiting naked short sales. The rules require all transactions over a prescribed size to be for no longer than standard (T+3) settlement and to be undertaken for guaranteed delivery. Throughout the period the LSE, in collaboration with the FSA, publishes statistics on open unsettled positions, in the form of a "pent up demand" disclosure. When these provisions are requested, the LSE will send out a market notice that the provisions are in effect. These provisions are very rarely requested by issuers and are infrequently invoked by the LSE.

Monitoring

8 The LSE monitors settlement data provided as part of the its feed of transaction data from Crest and regularly liaises with CRESTCo and member firms about large outstanding positions by member firms and/or in specific securities.

LIFFE

9 As mentioned earlier, short selling takes place in derivatives as well as the cash market. Market participants may choose to short sell using equity options which trade on LIFFE, the UK's main derivatives exchange. Like the LSE, LIFFE settlement is managed by LCH via CRESTCo but LIFFE handles the settlement discipline regime. LIFFE has rules for the non-fulfilment of settlement or payment obligations and has a fining regime to ensure contract terms are abided by. The benchmark guideline fine is £10 per lot (option on 1,000 shares) defaulting.

10 LIFFE reviews with the London Clearing House (LCH) the daily settlement performance of equity options for each member who makes or takes delivery of shares. The exchanges will send out a letter to the member firm in breach of the rules asking for an explanation within 10 business days. Disciplinary proceedings may follow. Sanctions are not imposed for single settlement or payment failure.

11 LIFFE reviews the settlement and clearing performance of all members on a monthly basis. Where a member has failed to settle or pay for 25 or more lots during a calendar month, disciplinary proceedings are initiated against that member. Where the same member has failed to settle or pay for between 1 and 25 lots for each of three consecutive months, disciplinary proceedings will be initiated against that member for the total number of lots defaulting.

12 LCH operates buy-in rules for equity options settlement on behalf of LIFFE. LCH institutes its own buy-in rules against parties who fail to deliver. The disciplinary regimes of Crest and of LIFFE for non-settlement/payment run alongside each other.

virt-x

13 Like the other exchanges, virt-x has responsibility for the settlement/payment discipline. Order Book trades are for settlement on T+3 days. Off-Order Book trades can be dealt for up to T+25 days and this settlement period can be extended following notification to virt-x.

14 If settlement has not occurred by the ISD, a member can request settlement discipline action from ISD+2 days. virt-x will inform the liable member in writing of the date by which they must settle the transaction. A charge of up to £75 is made for sending that letter. Then, if the liable member does not action the request by the specified date a one off charge of 0.25% of the transaction consideration is charged plus a further 0.1% of the transaction consideration for every day the settlement remains outstanding. Failure to settle within 7 business days of the specified date may result in disciplinary action, and may include buying-in the securities. Settlement on the due date averages 99.6% on the virt-x market and the settlement discipline provisions

have been used very rarely. Where they have been used, members have settled before the one-off charge would have been levied.

15 virt-x allows short selling as do all the exchanges. They have a specific rule about failure to deliver to the buyer of a short sale, be that a customer or an intermediary. This rule states that the seller is liable to compensate buying members for the full cost of not receiving that dividend.

16 virt-x do not have guaranteed delivery provisions.

17 The exchange reviews the information that they receive daily from CREST on members who are overdue for settlement. They do the same for information they receive from Euroclear/SIS.

CRESTCo

18 CRESTCo operate the primary settlement system for UK securities. Their settlement discipline regime is based on matching and settlement rates calculated over the business days in a two month period.

19 Market firms (i.e. those that are members of the LSE, LIFFE or virt-x) are not expected to match any trades by T+0 unless a CCP is involved. Where a CCP is involved the target is 90%. However, they are expected to match 98% of trades by T+1 and 100% by T+2, regardless of whether a CCP is involved or not. Stock loans need to be matched 100% by T+0. Fines are charged at £2 per day per trade where these targets are not met.

20 FTSE 350 sold transactions that remain unsettled after the ISD are also subject to fines. Members are fined if they do not meet specified targets. A firm is expected to settle 85% by ISD+0 and this increases in bands until 99% which is expected to be settled by ISD+20. Firms are not fined further for those transactions that remain unsettled after ISD+20. The fine is 0.05% of the transaction value (minimum £5).

List of questions

Q1: Do you agree with this assessment? If not, what is your assessment of recent trends in short selling?

Q2: Do you believe that the approach taken by the UK Exchanges and the FSA is the correct approach? Do you consider the present processes sufficiently address price volatility?

Q3: Do you have any comments on the conduct of business regime, as it currently applies to short selling and stock lending activity? Could the regime be improved in any way?

Q4: Are there any criteria regarding the information on short selling that we have missed and that we ought to consider?

Q5: Would this approach be desirable and why? How would the information be used and by whom? How often should the information be disclosed? What are your thoughts on the costs of this approach? Would this approach lead to more short selling being transacted in the derivatives markets?

Q6: Would certain market participants be disadvantaged by daily disclosures if the information were disclosed per security even if counterparties were not identified?

Q7: Would you consider it necessary to capture all short positions in all derivatives markets, including the non-exchange market (over-the-counter market)? How would the information about derivative short positions be useful? What feedback can you give us on the possible cost implications?

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Q11: Do you think that 'naked' short sales should be disclosed to the market? How would you use that information? Would any market participants be disadvantaged by such a disclosure?

Q12: Do you consider that this option should be followed up?

Q13: Do you consider that shortening the timeframe would help avoid settlement disruption in less liquid securities? Are there other suggestions on settlement and delivery, particularly for short sales, which you believe would be beneficial?

Q14: Do you think all short sales should be transacted with guaranteed delivery? (See Annex B, paragraph 6.)

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