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Friday 3 March 2023

Dear HM Treasury colleagues,

Short Selling Regulation Review: Call for Evidence

We welcome the opportunity to respond to your Call for Evidence on the Short Selling Regulation Review.

The Quoted Companies Alliance *Secondary Markets Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-sized quoted companies. A list of Expert Group members can be found in Appendix A.

Overall, we welcome HM Treasury's exploration of the Short Selling Regulation (SSR). We believe that short selling plays an important role in the functioning of the UK's capital markets, helping to achieve price efficiency and ensure liquidity.

Our two key concerns with the SSR are in relation to the disproportionate burden the Regulation places on short sellers, and the duplicative nature of its disclosure requirements. Therefore, we believe that it is important to modify the regime so that it is not only appropriate for the UK's markets, but also that HM Treasury considers the SSR in the context of the wider regulatory framework to ensure that requirements are not duplicative and burdens are minimised.

If you would like to discuss our response in more detail, please do not hesitate to contact us.

Yours sincerely,

A handwritten signature in blue ink that reads "James Ashton".

James Ashton
Chief Executive

Q1 Do you agree that the activity of short selling plays an important role in the efficient functioning of financial markets?

Yes – we agree that short selling plays an important role in the efficient functioning of the UK’s capital markets. The activity of short selling helps to ensure that prices are accurately reflective of both demand and supply from within the market. This provides balance to the market and assists with the provision of liquidity, which is especially important for small and mid-sized quoted companies.

Overall, we see that there are five key benefits that are produced as a result of short selling. Namely, these are: price efficiency and discovery; liquidity; trading; hedging; and improvements to corporate practices and conduct. We provide an explanation for each of these benefits below:

1. Price efficiency and discovery – the activity of short selling actively contributes to the accuracy and efficiency of prices in the market. It ensures that prices accurately reflect the underlying value of assets as both positive and negative information about a stock or market is publicly available. Without short selling, stock prices would face an upward bias and would fail to reflect the underlying fundamentals. This helps to prevent prices from becoming artificially inflated during upticks in market confidence and can correct prices during periods of uncertainty.
2. Liquidity – short selling positively impacts overall market quality as it leads to improvements in market liquidity. If short selling was restricted for a particular security, it would prevent market participants from trading on negative information. This reduces price efficiency (as described above), leading to prices that are less reflective of current information. As a result, market makers and liquidity providers would be forced to offer higher bid-offer spreads in order to compensate for the higher degree of pricing errors, which would mean increased trading costs and a reduction in liquidity.
3. Trading – short selling can help to make it easier for investors to trade in certain stocks by allowing them to sell shares that they do not own. This produces the effect of making it easier for investors to find a buyer and seller for a particular stock.
4. Hedging – short selling can assist the strategy of hedging, helping to reduce the risk of loss of a market participant’s existing position.
5. Improvements to corporate practices – short selling can positively influence and improve levels of corporate practices. Short selling acts as an external disciplining mechanism and encourages firms to improve their conduct and corporate practices.

We consider that these benefits lead to improvements in the overall functioning and efficiency of the market.

Q2 Do you think that the activity of short selling should be regulated in the UK? Please briefly explain why or why not

Yes – we believe that the activity of short selling should be regulated in the UK. Short selling can be vulnerable to market abuse. Regulation can help to prevent this, helping to protect investors and the market.

However, as a result of the benefits that the activity of short selling produces (as highlighted in our answer to Q1 above), it is important that this regulation does not impede its functioning.

Q3 Do you think the SSR puts a proportionate regulatory burden on short sellers in the UK market? Please briefly set out why.

No – we do not consider that the SSR puts a proportionate regulatory burden on short sellers in the UK market. The regulatory burden for these market participants is considerable, and represents another element of the UK's markets that is rigid, time-consuming and prohibitive.

For example, the current process of registering for short selling exemption under the current regime requires foresight on the expected daily and weekly volume of shares to be traded on an individual security basis is an overly manual and labour-intensive task for market maker and liquidity provider firms. Moreover, the requirement for market makers to submit a notification to the FCA in writing at least 30 calendar days before they intend to use it to demonstrate that they are a market maker and intending to commence market making in the relevant financial instruments can delay processes and is ineffective. It is also not commensurate with how processes operate within firms where, for any number of reasons, the decision to commence market making activities is often far quicker with applications to the relevant regulated market being made for commencement the following day. This is particularly the case in fast-moving market conditions when dynamism and flexibility are necessary.

We urge HM Treasury to amend this requirement and consider whether the requirement to make a notification can be made faster, simpler and effective immediately or, where the market maker has satisfied all relevant eligibility conditions, retrospectively. Alternatively, HM Treasury could consider giving registered market makers an automatic exemption from the securities in which they are registered to make a market in.

Q4 Are there aspects of the SSR which you consider to be essential for ensuring market stability and confidence in the activity of short selling?

Yes, although we consider many of the beneficial aspects of the SSR either are or should be covered by existing Rules.

For example, one of the key benefits of the SSR is that it helps to improve transparency within the market, helping to ensure stability and confidence. The requirement for short positions to be disclosed publicly allows investors to see the level of short selling activity. Disclosure and transparency of positions held are, however, already addressed by the Disclosure Guidance and Transparency Rules (DTRs). The requirements of the DTRs should be expanded to include short, as well as long, positions.

Furthermore, the ban on uncovered short selling helps to achieve market stability by helping to ensure that prices are not manipulated. It also helps to improve settlement by ensuring sellers have a sufficient number of securities in order to meet their obligations. However, the ban on uncovered short selling does have the potential to impede price formation as the requirements to cover a short sale create barriers that lead to price inflation. Any manipulative aspects of short selling are already covered by MAR and settlement discipline falls under the CSDR and, in some cases, within the rules of the relevant regulated market or MTF.

Q5 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?

On the whole, and at a minimum, we believe that it is important to modify the existing SSR so that it is reflective of, and appropriate for, the UK's markets. In this light, we welcome HM Treasury's decision to review the SSR and seek to modify elements of it.

However, it is the view of some of our membership that there is a case for more fundamental reform. This view is founded on the basis that almost the entirety, if not all, of the requirements and disclosures made under the SSR are, or should be, covered by other pieces of regulation, such as the Market Abuse Regulation. It is the view of these members that the SSR could be reformed more broadly and that the majority of its requirements could be reshaped or removed entirely.

Therefore, we urge HM Treasury to not only modify the existing SSR to reflect the UK's markets but to also consider the SSR in the context of the wider regulatory framework and ensure that requirements are not duplicative.

Q6 Are there aspects of other jurisdictions' short selling regulations that you think operate better than the SSR?

We have no comments.

Q7 Do you consider that uncovered short selling restrictions under the SSR are appropriate?

As highlighted above in our answer to Q4, the ban on uncovered short selling helps to ensure that prices are not manipulated, that settlement can be achieved and that there is a stable and orderly market.

That being said, the restrictions on uncovered short selling are strict and this does have implications for asset prices and valuations, which can be long-term.

Q8 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?

No – we do not consider that current uncovered short selling restrictions are working completely effectively due to the one-size-fits-all approach of the SSR.

The uncovered short selling restrictions are effective for larger, more liquid stocks, such as the constituents of the FTSE 100. However, the regime works much less effectively for small-cap stocks that are less liquid as there is likely to be fewer lending facilities available.

Therefore, we urge HM Treasury to consider separate requirements for small-caps to avoid any potential unintended consequences. These unintended consequences could result in the withdrawal of market makers and the further removal of capital from this part of the market particularly where draconian buy-in rules, as proposed under the Settlement Discipline Regime (SDR) part of the wider EU Central Securities Depositories Regulation (CSDR) would mean that there was additional and significant financial risk associated with being a market maker in such securities in addition to the market risk already assumed in pursuing liquidity obligations.

Q9 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?

Overall, we do not consider that there is sufficient evidence to suggest short selling activity is causing settlement failure to a degree that UK settlement discipline arrangements need to be changed to reduce the risk of short selling causing settlement failure. We do not consider that short selling is necessarily a major

cause or concern of settlement failure, as there are many factors that can contribute to securities being delivered in a timely manner. Settlement failure can occur, for instance, as a result of operational errors, poor risk management systems, or a lack of liquidity.

The SSR currently requires firms to have robust risk management systems and the market infrastructure, through Central Counterparties (CCPs) and Central Security Depositories (CSDs), are also in place to help ensure settlement.

The QCA has been heavily involved in discussions around settlement in the past, in particular around proposals from the EU on the CSDR from around 2011 until 2020 when the decision was made not to implement the SDR in the UK. Following this, we were actively involved in conversations with HM Treasury over the UK's settlement regime, where we stressed that the current model is efficient and fit for purpose and helps to encourage the provision of liquidity, which is especially important for companies at the smaller end of the market. We also understand that the market consensus was that a maintenance of the status quo was preferred.

It is therefore unclear why this area is being re-visited by HM Treasury, and it is not clear there is sufficient evidence to suggest market failure as regards settlement performance. As a result, we see there being limited, if any, justification for introducing new measures around settlement discipline regimes. Doing so may result in significant adverse consequences, which are likely to be particularly detrimental to the smaller end of the market.

Q10 Should the FCA specifically monitor short selling?

Yes – we believe that the FCA should monitor short selling as it helps to ensure market stability and confidence.

Q11 Does the FCA monitoring of short selling help support market integrity and market confidence?

Yes – as stated in our answer to Q10.

Q12 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?

We have no comments.

Q13 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?

We have no comments.

Q14 Are there other adjustments to the reporting requirements which you would suggest?

We have no comments.

Q15 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?

Yes – on the whole, we support the requirement to publicly disclose net short positions under the SSR, but note that this obligation might fit more logically under the DTR. This helps to ensure equal disclosure of long and short positions, helping to increase transparency and thus reducing volatility and prevent market manipulation.

Q16 How do you use public net short position disclosures and how does it support your firm's activity or the market?

As a membership organisation we do not use this information. However, the feedback we received from members was that the data is useful and provides insight into market influences and helps to prevent an imbalance of information.

Q17 Do the public disclosure requirements contribute to or create any unnecessary barriers to short selling? If yes, please provide details.

We have no comments.

Q18 Are there public disclosure requirements that could be changed to remove any unnecessary barriers to short selling? For example, do the identities of the position holders need to be disclosed and what would be the impact on your firm and the market from removing this?

Were the identity of the short position holders to be removed, this could potentially cause additional settlement risk to those market makers and liquidity providers that use that information for the purposes of ensuring their compliance with their own settlement obligations. This is more relevant to those smaller capitalised securities where borrowing provisions available on the larger FTSE securities is not replicated.

Q19 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?

We have no comments.

Q20 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?

Yes – our members consider that the market maker exemption regime in the SSR functions efficiently, stating that it provides sufficient flexibility and restriction to allow market makers to effectively provide liquidity.

We believe that it is essential that this exemption remains in order to continue to incentivise the market makers to continue to provide liquidity to ensure the market functions effectively.

As stated in our answer to Q3 above, we believe that the overtly manual process of not only completing the form but ensuring its submission and application of the 30-day rule, is ineffective and should be reconsidered by HM Treasury.

Q21 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?

As far as we are aware, the FCA has never used its powers to ban short selling. Therefore, it does not appear overly necessary that the bans are in place and could be removed without any impact.

Q22 Do you think any changes could be made to increase the effectiveness of existing short selling bans?

Please see answer to Q21 above.

Q23 Are there any alternative arrangements to short selling bans that could be put in place (including arrangements from other jurisdictions)?

We have no comments.

Q24 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?

We have no comments.

Q25 Please provide any further views on the SSR, including views on the arrangements relating to sovereign debt and sovereign credit default swaps.

We have no comments.

Q26 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).

We have no comments.

Appendix A

The Quoted Companies Alliance *Secondary Markets Expert Group*

Mark Tubby (Chair)	finCapp PLC
Amber Wood (Deputy Chair)	Cenkos Securities Plc
Jasper Berry	W.H. Ireland
Andrew Collins	Charles Russell Speechlys LLP
Sunil Dhall	Peel Hunt LLP
Nick Dilworth	Winterflood Securities Ltd
Fraser Elms	Herald Investment Management Ltd
William Garner	Charles Russell Speechlys
Jon Gerty	Peel Hunt LLP
Mitchell Gibb	Stifel
Keith Hiscock	Hardman & Co.
Sacha Morris	Hybridan LLP
Jeremy Phillips	CMS
Katie Potts	Herald Investment Management
Simon Rafferty	Winterflood Securities Ltd
James Stapleton	Winterflood Securities Ltd
Stephen Streater	Blackbird PLC
Peter Swabey	Corporate Governance Institute