

Short Selling Regulation Review

Government response

July 2023

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Contents

Chapter 1	Executive summary	6
Chapter 2	Introduction	7
Chapter 3	Feedback to the Call for Evidence and next steps	9

Chapter 1

Executive summary

1.1 The Financial Services and Markets Act 2023 (FSMA 2023) repeals retained EU law relating to financial services. This enables the government to deliver a Smarter Regulatory Framework for financial services. Retained EU law will be repealed and replaced with rules set by our independent and expert regulators, operating within a framework set by government and Parliament. As part of this, the government is committed to putting in place a regulatory regime for short selling that is tailored to the UK, which supports market integrity and bolsters the competitiveness of UK financial markets.

1.2 The government is grateful for the range of feedback provided in response to the government's Call for Evidence on the Short Selling Regulation (SSR)¹. The government will give the Financial Conduct Authority (FCA) rule-making powers to deliver the firm-facing aspects of the new UK short selling regime. When the FCA consults on a short selling regime that will replace the SSR, it will take the responses to the Call for Evidence and the views of the government, as set out in this response, into account.

1.3 This approach will ensure that the UK has an agile and internationally respected short selling regime that supports a thriving, internationally competitive financial services sector, contributing to the UK's economic growth while providing appropriate safeguards.

1.4 Based on the feedback provided, the government is also making two key changes to improve the UK's short selling regulatory framework. Specifically:

- I. **The government will replace the current public disclosure regime based on individual net short positions with an aggregated net short position disclosure regime.**
- II. **The government will increase the current disclosure threshold for net short position reporting to the FCA from 0.1% to 0.2%.**

1.5 The government believes that these changes will ensure that the UK's regulatory framework for short selling supports effective market functioning, with appropriate protections for investors and without placing a disproportionate burden on industry.

¹ Regulation 236/2012/EU of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, as it has been retained in UK law following EU Exit

Chapter 2

Introduction

2.1 The Chancellor's Edinburgh Reforms, announced on 9 December 2022, set out a package of changes to drive growth and competitiveness in the financial services sector. As part of these reforms the government published a policy statement on the approach to repealing retained EU law (REUL)² As part of these reforms the government published a policy statement on the approach to repealing retained EU law (REUL)¹ on financial services in order to deliver a Smarter Regulatory Framework tailored to the UK. As part of this programme, the government launched a Call for Evidence on the SSR, which regulates short selling in the UK.

2.2 The government sees short selling as an essential tool to facilitate effective market functioning. It supports liquidity, risk management and effective price discovery. However, the government recognises that there can also be risks associated with short selling, which can impact on wider market confidence. For this reason, the regulatory regime for short selling should facilitate short selling and the benefits it provides to orderly and effective market functioning, while protecting against risks.

2.3 The Call for Evidence asked for feedback on the core elements of the SSR, to understand how the regime could be reformed to make it work better for UK markets. As per table 2.A below, we received 856 responses from industry, academia, and individual retail investors. Industry responses were from across the financial services sector, including funds, issuers, market makers, securities lenders, and investment banks. Many responses from retail investors were similar, often based on template responses promoted on social media, and appeared largely to provide feedback on the US model of regulation rather than the UK's regime. The government recognises the importance of gathering feedback from a wide and varied group of stakeholders to make good policy decisions and is therefore grateful for all the contributions made by respondents.

2.4 This document summarises the feedback received in the Call for Evidence and, in light of the feedback received, sets out the government's response to the issues raised at a high-level, with further detail to be set out in a draft Statutory Instrument, and ultimately in FCA rules. It is designed to be read alongside the Call for Evidence document that was published on 9 December 2022, as well as the consultation published in parallel to this document on aspects of the

² <https://www.gov.uk/government/publications/building-a-smarter-financial-services-framework-for-the-uk>

SSR related to UK sovereign debt and sovereign credit default swaps (CDS)³.

2.5 As per HM Treasury's SRF delivery plan⁴, where appropriate, the government will seek technical feedback on the draft Statutory Instrument(s) that implement it in due course. This will give stakeholders an opportunity to provide feedback on whether the draft legislation achieves the government's policy intent, and to highlight any unintended consequences. The FCA will consider and consult on its proposed rules for the revised UK short selling regulatory framework where appropriate in due course.

Figure 2.A Overview of Call for Evidence respondents

Respondents			
Funds	6	Investment banks	3
Market makers	3	Issuers	3
Securities lenders	2	Software companies, fintech	2
Trading venues	1	Think tank, Legal, Academia	5
Retail investors	831		

³ <https://www.gov.uk/government/consultations/short-selling-regulation-consultation-sovereign-debt-and-credit-default-swaps>

⁴ <https://www.gov.uk/government/publications/building-a-smarter-financial-services-regulatory-framework-delivery-plan>

Chapter 3

Feedback to the Call for Evidence and next steps

Overarching questions on short selling

3.1 The first six questions in the Call for Evidence asked for general views on the role of short selling in the market, as well as the current UK regulatory regime.

3.2 Industry respondents from across the financial services sector overwhelmingly agreed with the government's position that short selling generally plays an important and beneficial role in financial markets. Responses from retail investors were more mixed, with many respondents expressing reservations about the benefits of short selling for price discovery and market efficiency.

3.3 Respondents were unanimously in favour of short selling being regulated in the UK. Common themes across responses were the need for regulation to restrict uncovered short selling of shares, promote market transparency, prevent market abuse, and ensure overall market confidence.

3.4 A key issue the government was seeking views on in the Call for Evidence was whether the current SSR puts a proportionate regulatory burden on short sellers. There were several industry responses that highlighted areas of concern. These aligned with the areas the government had identified and are discussed in more detail below.

3.5 Some retail respondents felt that the regime should go further to prevent settlement failures, even if this necessitates an increased burden on short sellers. They raised further settlement-related concerns which are discussed in more detail below.

3.6 Respondents highlighted several aspects of SSR that are essential to ensure market stability and confidence in short selling activity. The most cited aspects were covering requirements for shares, the market maker exemption, public disclosure requirements and position reporting to the FCA.

3.7 The government was also interested in views on whether stakeholders would prefer to modify the existing SSR, or whether there was a case for a fundamental reform. Respondents largely did not see the need for a fundamental reform of the current regime, but rather that modifications to the existing framework would be sufficient to alleviate disproportionate burdens and to improve the effectiveness and efficiency of the regime.

3.8 There were several elements of other jurisdictions' short selling regimes that some respondents commented on. Various retail investors, including a significant proportion of the responses submitted based on templates circulated online, were supportive of incoming changes to US short selling requirements, particularly public disclosure requirements, restrictions on uncovered short selling, transaction-level securities lending reporting and penalties for market manipulation, although it was not clear whether they were comparing this against the UK regime or simply against existing US requirements. Several industry respondents also highlighted the proposed US public disclosure regime based on aggregated short position reports compared to the current UK regime based on individual net short positions. Some respondents supported elements of other jurisdictions' regimes that they said would streamline net short position reporting to the FCA, such as moving from a list of exempt third country shares to a Hong Kong-style 'positive' list of in scope shares, as well as operational changes to automate net short position report submissions to the FCA.

Box 3.A Government response

Overall, the government continues to believe that short selling brings significant benefits to UK financial markets, and the consultation responses support this view. However, while parts of the regime are working well, the Government's conclusion from this consultation process is that it is clear that reform is necessary. To ensure that these benefits are realised, the UK needs a robust, UK-tailored regime which provides relevant information for market participants and the FCA and places a more proportionate burden on industry.

Restrictions on 'uncovered' short selling

3.9 In the Call for Evidence, the government said that it intended to maintain the ban on uncovered short selling for shares, and that this is a core part of a short selling regime. The purpose of covering requirements is to prevent settlement failure disrupting the orderly functioning of the market and to prevent shorting of more shares than already exist in the market. Restrictions on uncovered short selling of shares are a common feature of short selling regulation internationally.

3.10 There was overwhelming consensus from respondents that uncovered short selling of shares should continue to be prohibited. Industry respondents broadly agreed that the current UK covering requirements are effective. Most retail investors felt that the current arrangements should be combined with stricter settlement discipline rules, although this appeared to be focused on US settlement failures. Additionally, some retail investors argued that market makers should not be exempt from covering requirements.

3.11 Some industry respondents highlighted that while the current covering arrangements are effective for liquid stocks, they have proved to be less effective for less liquid stocks with fewer lending facilities.

They recommended having separate requirements for liquid and illiquid stocks. However, other respondents cautioned against changes to the current covering arrangements on the basis that the current requirements work well to prevent settlement issues without being unnecessarily burdensome.

3.12 Industry respondents from across the financial services sector said they had not experienced settlement issues as a result of short selling activity. While many responses from retail investors linked settlement failure to short selling, responses typically pointed to evidence of such settlement issues in the US rather than the UK.

Box 3.B Government response

Based on the feedback received, the government still considers prohibitions on uncovered short selling of shares to be a core part of the regulation of short selling. The government plans to give the FCA the ability to make regulations to prohibit uncovered short selling. The FCA will take the outcome of the Call for Evidence into account when considering and consulting on restrictions on uncovered short selling.

The government will consider the feedback on settlement discipline when it repeals and replaces the Central Securities Depositories Regulation (CSDR), in due course.

Position Reporting to the FCA

3.13 The Call for Evidence sought feedback on the current position reporting requirements under the SSR. Under the SSR, persons with net short positions above 0.1% of issued share capital of a publicly traded company are required to notify the FCA. Persons must then report incremental 0.1% changes to their positions above that threshold.

3.14 All respondents believed that the FCA should monitor short selling activity. Commonly cited reasons included to ensure market stability and integrity, to detect potential market abuse and to detect potential corporate misconduct issues.

3.15 However, industry respondents representing firms that are required to submit reports under the regime (such as funds and investment banks) highlighted various factors that make the current reporting regime disproportionately burdensome. These included:

- The initial 0.1% disclosure threshold, which was lowered from 0.2% in March 2020 to increase the FCA's oversight of short selling activity during the Covid-19 pandemic. Respondents highlighted that this has led to a significant increase in the number of reports they are required to submit to the FCA. One respondent argued that the disclosure threshold should be higher on the basis that 0.1% net short positions do not represent a directional trading strategy.

- The 0.1% incremental disclosure thresholds. Some respondents felt these should be widened, which would reduce the total number of reports they are required to submit. D
- Operational arrangements to submit net short position reports to the relevant reporting FCA portal. For example, firms are currently required to manually input individual position reports into the FCA's reporting portal, which makes it more time consuming for firms to submit reports. Respondents felt that arrangements could be improved to allow for more automated report submission, which would reduce the time and resources required to report.
- The 15:30 next trading day report submission deadline. Some respondents, particularly firms that operate across jurisdictions in different time zones, highlighted that extending this deadline to midnight on the next trading day, would significantly alleviate the reporting burden.
- The lack of a definitive data source (or 'golden source') for total issued share capital for the purpose of calculating net short positions. Respondents highlighted that different sources of issued share capital can contradict one another, which adds unnecessary complexity to net short position calculations.
- The current 'negative' list of exempt overseas shares, whereby the FCA publishes a list of shares that are exempt from the SSR because their principal trading venue is overseas. Respondents said that a 'positive' list of shares in scope of the regime would significantly streamline the net short position reporting process. This is discussed further in the overseas shares section below.

Box 3.C Government response

The government agrees with respondents that FCA monitoring of short selling activity is important to support market integrity and market confidence. However, it is also important that the UK's short selling rules do not place a disproportionate burden on reporting firms.

In light of the feedback received, the government will increase the disclosure threshold from 0.1% to 0.2% of total issued share capital. The government considers that a 0.2% threshold strikes a better balance between providing the FCA with sufficient data to carry out its functions, and appropriate burdens on reporting firms.

The government plans to enable the FCA to make rules about the regime. The FCA will take the outcome of the Call for Evidence into account, including feedback on the current report submission deadline, the lack of information on total issued capital, and the FCA's

operational arrangements for position reporting, when considering and consulting on the net short position reporting regime.

Public Disclosure

3.16 As set out in the Call for Evidence, the government believes that the purpose of public disclosure on short selling is to provide investors with information and transparency on how it affects the price of shares. This, in turn, will provide certainty and confidence to the market. Under the SSR, net short positions above 0.5% of total issued share capital are published by the FCA to the market, including the identity of the short seller.

3.17 Respondents expressed a range of views in response to the questions on public disclosure in the Call for Evidence. While the vast majority of respondents agreed that the UK should have some form of public disclosure on short selling activity, there were varying views on individual elements of the regime.

3.18 A number of industry respondents, particularly from the fund and asset management sectors, argued that the current short selling rules negatively impact the price discovery process. They highlighted concerns that the current regime creates risks around copycat behaviour and short squeezes when individual positions are disclosed publicly, which they say in turn discourages short selling activity above the 0.5% disclosure threshold. They also argued that individual position disclosures reveal proprietary trading strategies, which discourages investment in research to inform their strategies.

3.19 However, some other industry respondents suggested that the current individual position disclosure regime provides useful information to the market to support their activities. Some respondents explained that they use the information for liquidity and risk management purposes. Others, particularly from the issuer community, argued that the current individual disclosure regime helps to inform their corporate engagement with their investors.

3.20 In the Call for Evidence, the government asked for views on how the public disclosure requirements could be improved to increase transparency to the market. In particular, the government asked for views on the disclosure of aggregated net short positions to either supplement or replace the current regime. There was a split in responses to this question. Several respondents, particularly from the funds community, argued that an aggregate regime would provide better information on the overall impact of short selling on price dynamics, without the risks of distortionary market behaviours highlighted above. Several respondents, particularly investment banks and securities lenders, saw benefits in the current regime, but also thought that an aggregate net short position disclosure regime would provide useful information. One respondent argued that an aggregated

disclosure regime would not provide the level of transparency provided by the current regime.

Box 3.D Government response

The government believes that aggregated net short position disclosures would provide transparency on short selling activity, while avoiding the potential distortive impacts of the current public disclosure regime.

As such, instead of individual net short positions in shares above 0.5% being published, the government will implement an aggregated net short positions disclosure model. This will provide the market with greater transparency on the overall net short position in a company's share than the current regime, but without the problems identified in the feedback to the Call for Evidence with naming individual short sellers. Like the current individual position public disclosure regime, the FCA will be responsible for publishing aggregated net short positions.

The government will give the FCA the ability to make any rules on the functioning of public disclosure arrangements that it believes are necessary to administer this aggregated net short position disclosure model. The FCA will take the outcome of the Call for Evidence into account when considering and consulting on any public disclosure rules.

Market Maker Exemption

3.21 Market makers play an important role in providing liquidity to the market. To allow market makers to effectively carry out their function without undue burden, they are exempt from covering and disclosure requirements under the SSR. To receive an exemption, market makers are required to notify the FCA at least 30 calendar days before they intend to make use of the exemption.

3.22 Industry respondents were overwhelmingly in favour of the market maker exemption and emphasised that the current regime is effective overall. Retail respondents were more sceptical and felt that it was open to abuse without effective enforcement. However, most criticism of the market maker exemption by retail respondents was based on a perceived lack of enforcement of US market maker rules in the US, rather than specific concerns with the UK regime.

3.23 Several industry responses highlighted that the current regime could be streamlined to lower administrative burdens for firms. The 30-day time period between notification and ability to use the exemption was highlighted as preventing market makers from being able to quickly respond to market events and changes. Many of the respondents who highlighted scope for streamlining the regime argued that notifications should be effective immediately, with the FCA

being able to monitor the use of exemptions and to subsequently challenge and remove exemptions that are being used incorrectly. The current requirement for market makers to notify exemptions at an instrument-level, as well as operational arrangements for submitting exemptions were highlighted as burdensome.

3.24 Some respondents also suggested that the government should explore further third-country equivalence decisions under Article 16(2) of the SSR, beyond the current equivalence decision for the EU.

Box 3.E Government response

The government thinks that the market maker exemption is an essential element of the regulation of short selling. The government agrees that the current regime could be streamlined to lower administrative burdens for firms.

The government envisages that the detail of the market maker exemption requirements will be in FCA rules. The FCA will take the outcome of the Call for Evidence into account, including streamlining arrangements, when considering and consulting on rules relating to the market maker exemption.

The government is giving further thought to feedback received on the current third-country equivalence regime related to the market maker exemption.

Emergency Intervention Powers

3.25 The SSR gives the FCA powers to require additional short selling-related information to be provided, and to restrict short selling, in exceptional circumstances where there is a serious threat to financial stability or market confidence, or in order to prevent a disorderly decline in the price of a financial instrument. The FCA has previously publicly stated that it would set a high bar for restricting short selling, and it was against this backdrop that the government was interested in exploring policy options related to these powers.

3.26 Respondents had mixed views on whether the FCA should have the ability to ban short selling. Many respondents had reservations around the effectiveness of short selling bans in preventing price falls and volatility, but nevertheless felt that the FCA should retain emergency intervention powers for exceptional circumstances, recognising the FCA's approach towards imposing short selling bans. Conversely, several respondents felt that given the FCA has never initiated a ban under the SSR, the powers could be removed without any impact. One respondent suggested that it would be more appropriate to suspend trading in both directions if required, arguing that a short selling ban would only result in suppressing one side of the price formation mechanism. A further group of respondents argued

that short selling bans should be removed on the basis that they are ineffective in preventing price falls while being harmful to orderly market functioning.

3.27 Respondents suggested several changes to the current short selling ban powers. Several respondents recommended exempting indices, baskets, and Exchange Traded Funds (ETFs) from the scope of bans. A number of respondents also suggested exempting hedging activity from the scope of bans, or only applying bans to new net short positions.

Box 3.F Government response

The government agrees that emergency intervention powers relating to short selling should only be used in exceptional circumstances, given the detrimental impact they potentially can have on the market. In light of the feedback, the government believes that the FCA should retain emergency intervention powers for exceptional circumstances, where there is a serious threat to financial stability or market confidence, or in order to prevent a disorderly decline in the price of a financial instrument.

As part of the retained emergency intervention powers, the government will require the FCA to set out its approach to using these powers. The government considers that this should provide the market with greater upfront clarity on the FCA's use of its emergency powers. The FCA will consult on this approach in due course.

Overseas Shares

3.28 Under the current regime, the FCA is required to maintain a list of shares which are exempt from key obligations in the SSR where the principal venue for trading of the share is in an overseas country. This list is a 'negative' list of exempt overseas shares rather than a 'positive' list of shares in scope of these SSR obligations.

3.29 Call for Evidence respondents highlighted the current 'negative' list of exempt overseas shares as causing issues when identifying which shares should be reported to the FCA. Respondents said that data quality issues with the list itself, as well as with additional data sources used to determine reporting eligibility, added friction and uncertainty to complying with the SSR regime. A large majority of respondents recommended moving from a list of exempt overseas shares to a positive list of UK and third-country shares that are in scope of the SSR, on the basis that it would improve operational efficiency and certainty in meeting disclosure requirements by more clearly identifying which shares they should report.

3.30 Respondents also highlighted issues with the current requirement to only review and update the list every two years. Respondents suggested that this creates uncertainty for firms when determining whether a net short position is reportable for shares which

appear to principally be traded outside the UK, but which do not appear on the UK list of exempted shares. Respondents suggested that the list should be updated more frequently than every two years.

3.31 Finally, various respondents highlighted certain issues they were experiencing with the current technical format of the FCA list. The current list is not available via an electronic form, but rather has to be downloaded as a spreadsheet. Respondents requested that the list be made more machine-readable to facilitate automated disclosure.

Box 3.G Government response

The government recognises the feedback provided on the issues with the current 'negative' list of exempt overseas shares and the benefits of moving to a 'positive' list of in scope shares. The government plans to enable the FCA to make rules about exempt share arrangements. The FCA will retain its current role of determining where shares are principally traded and will take the outcome of the Call for Evidence into account, including the feedback on moving to a positive list, when considering and consulting on rules on arrangements for overseas shares.

Other considerations

3.32 In the 'other considerations' section of the Call for Evidence, the government asked for further views on the SSR, including elements of the SSR relating to sovereign debt and sovereign credit default swaps (CDS), as well as the operational impact of changes to the SSR for firms operating in multiple jurisdictions.

3.33 The government has published a separate consultation document on sovereign debt and CDS aspects of the regime, which summarises views provided in response to the Call for Evidence⁵.

3.34 More broadly, several retail respondents recommended broader changes to the financial services framework beyond the scope of this review of the SSR. For example, some respondents suggested ideas such as banning Payment For Order Flow, which is already banned in the UK. Other suggestions, such as greater transparency on derivative trading and greater scrutiny of hedge funds will be considered where appropriate as part of the government's wider work to Build a Smarter Regulatory Framework in the UK. Finally, some retail respondents proposed entirely banning the trading of derivatives on UK markets or banning off-venue trading of financial instruments. The government does not intend to take these suggestions forward.

3.35 Almost all respondents suggested that making changes to the UK SSR would not in itself bring significant additional operational

⁵ <https://www.gov.uk/government/consultations/short-selling-regulation-consultation-sovereign-debt-and-credit-default-swaps>

burdens for international firms subject to different short selling regimes. Industry respondents argued that the benefits of the changes for which they were advocating would outweigh divergence costs or short-term transitional costs.

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