1 May 2009

Greg Tanzer
Secretary General
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Dear Mr Tanzer

Public comment on regulation of short selling

Our associations (International Securities Lending Association, London Investment Banking Association, Pan Asia Securities Lending Association, Risk Management Association, Securities Industry and Financial Markets Association), represent banks and other financial institutions involved in securities lending, borrowing and trading in Europe, North America and Asia. On behalf of our members, we are grateful for the opportunity to submit these joint comments on the Consultation Report on the Regulation of Short Selling prepared by the Technical Committee.

We welcome the Committee's recognition of the important role that short selling plays in the market, including providing more efficient price discovery, mitigating bubbles, increasing market liquidity and facilitating hedging and risk management. We hope that regulators in countries that still have emergency restrictions on short selling in place will lift them in the near future, permitting short selling within a well-structured regulatory framework, based on the principles set out by the Committee. We note that empirical studies of the impact of short selling restrictions in a number of markets[1] confirm that they lead to reduced liquidity, wider bid/offer spreads and lower turnover, and may raise trading costs and increase price volatility.

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[1] For example, *Short Selling in the Hong Kong Stock Market*, Research Paper No. 42, Hong Kong Securities and Futures Commission, April 2009..

We back the Committee's call for a more consistent regulatory approach to short selling internationally in order to simplify and make less costly the compliance process for market participants that operate across many jurisdictions. Despite the Committee's clear support for consistency, it appears that coordination among regulators is still lacking. For example, in the United States, the SEC is considering whether to restore an uptick rule, while in the United Kingdom, the FSA has proposed disclosure of individual short position and in France the AMF has proposed a range of possible measures, including the flagging of short sales, disclosure of securities borrowing and mandatory buy-ins at T+5.

In general, we support the principles recommended by the Technical Committee, viz.

"1. Short selling activities should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets;

2. Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities;

3. Short selling should be subject to an effective compliance and enforcement system; and

4. Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development."

We have a number of detailed points on these principles and on how they are elaborated in the Consultation Report, which are set out below. For the most part, our comments repeat those submitted to the working group in December by SIFMA, ISLA and PASLA.

1. '*Definition of Short Selling*'

In general, we agree with the way that the Committee has defined 'short selling' in Appendix III of the Report. We would, however, call for explicit recognition that a contractual right to recall a security from loan is sufficient to provide cover and thus the sale of a security on loan that is subject to a contractual right of recall at any time is outside the definition of short selling.. We believe this falls within the circumstance where 'the seller has purchased or entered into an unconditional contract to purchase the stock but has not yet received delivery' because an open securities loan gives the lender the contractual right at any time to demand the return of the lent securities from the borrower by giving notice of the standard settlement time for the relevant market. Explicit clarification of this point would remove any ambiguity.

2. '*Short selling activities should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets*'

We note that the Committee has not made universal recommendations on measures such as tick rules and restrictions on naked short selling, stating that such measures may have different levels of effectiveness, depending on local market conditions. On balance, our view is that such measures have not to date been justified on cost: benefit grounds.

With regard to so-called ‘naked’ short selling, we agree that short sellers should always be in a position to settle the trade on the settlement date. However, in order to achieve this objective, we think it is unnecessary to prohibit naked short selling by requiring short sellers to own or have borrowed securities before the sale. It should be acceptable to borrow the securities after the sale but in time to settle the trade. In practical terms, securities dealers will often be in this position when providing liquidity to their customers. A requirement to have borrowed the securities before the sale adds a friction that ultimately raises trading costs for investors and may reduce market liquidity. Regulators may have particular concerns about the effect on market prices of large ‘naked’ short sales, beyond the reasonable size that could be borrowed for settlement. We believe that any such ‘manipulative’ naked short selling can be prevented by a combination of enforcement of regulations to prevent market abuse and effective settlement discipline.

As regards ‘tick rules’, we note that the US SEC is considering whether to re-introduce the uptick rule (either the SEC’s former one or a modified version) and/or a circuit breaker mechanism (either with a trading halt or in combination with a price test), and has issued proposals in this regard, inviting comment. The SEC’s former uptick rule was abolished in July 2007, after more than two years of analysis, as a result of the SEC’s conclusion that it brought no net benefit to the market and may in fact reduce market liquidity. We recognize that the SEC’s new proposals are currently under review and firm conclusions have not yet been reached. However, we note that implementing a tick rule using a consolidated price feed may be problematic and costly in today’s markets, which have seen a proliferation of trading venues in the United States and in the European Union following the introduction of MiFID.

3. ‘*An effective settlement discipline is the first pillar for an effective short selling regulatory regime*.’

We support settlement discipline regimes designed to encourage timely settlement and prevent persistent fails to deliver. But these should not be unduly restrictive in ways that penalise unintended failed trades excessively and may actually distort markets. In particular, any penalties or buy-in requirements should take effect after allowing market participants a reasonable period (eg three days) following the settlement date to deliver the securities.

An active securities lending market is key to preventing chains of failed trades (as recognised, for example, by the 1999 CPSS/IOSCO Report on Securities Lending and, in the European Union, by the 2009 CESR/ESCB Recommendations for Securities Settlement Systems). In defining the penalties for failed settlements, it is important to distinguish between the various potential causes of a fail. For example, fails that result from administrative or operational errors should be treated differently from fails that result from naked short selling or manipulative conduct. If these distinctions are not clearly addressed, new regulations may lead to unintended consequences. For example, if institutional investors are concerned that they might be exposed to large penalties if securities recalled from loan transactions may not be returned in every instance in time to meet the settlement timetable, they may decide to withdraw from lending in that market, leading to more failed trades.

We would also add a note of caution on the call for shorter settlement cycles. While we support the view that settlement cycles should be no longer than T+3, the advantages of any further shortening need to be considered alongside the possible disadvantages including a possible increase in failed trades because of greater time pressure, particularly for cross-border trades, and the shorter window in which securities borrowings can be arranged in order to cover any failed trades.

4. '*Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities'*

For firms conducting a cross-border business, harmonization of the rules would significantly reduce the complexity and costs of compliance. We agree that any disclosure regime needs careful thought in relation to: (i) the regulatory goals behind the disclosure; (ii) whether the disclosure will provide meaningful information in support of those goals given the complexity involved (eg the need to avoid double counting, the sheer volume of data, etc.); and (iii) the compliance cost to institutions of producing the information for multiple regulators. Again we urge regulators to do full cost: benefit analysis of any proposed changes to ensure that any perceived benefits are not outweighed by the costs of disclosure.

We strongly encourage regulators to work together on harmonized disclosure requirements internationally and to look at short interest disclosure alongside existing requirements for disclosure of significant long holdings. The report leaves open questions such as net or gross reporting, the trigger level and frequency of reporting and the scope of reporting. We would urge further work by regulators towards harmonisation in these areas.

In relation to public disclosure, we think that any requirements need to be based on a clear understanding of the objectives. We can see a case that investors may benefit from reliable statistics about the aggregate net short position in individual shares across all disclosing entities. But we oppose any required public disclosure of individual institution or investor short positions. We do not believe that the public disclosure of individual institution or investor short positions would be useful to investors, nor would it improve market efficiency. Unlike long holders of shares, there is no argument for disclosure on the grounds of corporate control. On the other hand, public disclosure would reveal information about trading strategies in a way that might damage the interests of the parties involved and may potentially deter trading.

We assume that confidential disclosure to regulators would be primarily for the purpose of monitoring activity in order to investigate any cases of suspected market abuse.
To get the most accurate information, we believe that the best sources of position data are the investment managers or traders involved in taking the positions. Reporting obligations should focus on intended overall net short positions in particular shares (ie netting out gross long and gross short positions in different accounts). Monthly or twice-monthly reporting should be adequate to monitor these positions, with a reporting obligation triggered by crossing a materiality threshold expressed as a percentage of shares outstanding eg 0.5% and then increments of 0.5 percentage points. Any requirement to report individual positions should be designed on the same basis as and ideally combined with any collection of short position data in order to produce aggregate statistics on short interest in stocks.

We believe that the costs of a system based on flagging every short sale and cover short transaction would outweigh the benefits of such disclosure at transaction level. These costs would be particularly high in countries where short sales have not needed to be identified previously and therefore systems are not in place.

5. '*Short selling should be subject to an effective compliance and enforcement* system'

We think 'abusive' activities that might involve short selling should be controlled under general market abuse regulations in order, for example, to prevent spreading of market rumours or trading strategies designed to manipulate market prices. Given that short selling is not, of itself, abusive, we do not see a case for particular enforcement powers in relation to short selling. We also do not believe that market abuse regulations are the appropriate instrument for implementing any disclosure requirements for short sales.

If regulators decide to create a compliance and enforcement regime around settlement failures, we urge the promulgation of clear exceptions for operational or administrative errors where there is no indication of naked short selling or manipulative actions or intent.

6. '*Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development*'

We support the Committee's view that any short selling regulations should be applied flexibly in order not to impede *bona fide* hedging and market making activities. On the basis that disclosure is used by regulators to monitor for abusive short selling and perhaps to calculate aggregate statistics for publication, we think reporting should focus on net short positions and exclude short selling by banks and dealers in the course of providing liquidity to their customers (customer facilitation) or *bona fide* hedging of positions. This includes hedging of commitments by underwriters and sub-underwriters, which is key to the capital raising process for issuers. In other words, the reporting should focus on positions taken on the basis of an investment decision that the value of the share will fall. In the case of banks and dealers, it should be limited to proprietary trading positions taken by the firm, and not include short sale activity in connection with customer facilitation accounts.

I hope these comments are helpful. If you have any further questions please do not hesitate to contact us.

Yours sincerely,

David Rule	Curtis Knight	William J Ferrari	Ira Hammerman	Lawrence Komo
CEO	Director	Director	General Counsel	Chairman
ISLA	RMA	LIBA	SIFMA	PASLA

About the associations:

ISLA is a trade association established in 1989 to represent the common interests of participants in the international securities lending industry. ISLA has more than 100 members comprising insurance companies, pension funds, asset managers, banks and securities dealers representing more than 4,000 clients. More information can be found at www.isla.co.uk.

LIBA is the principal trade association in the United Kingdom for firms which are active in the investment banking and securities industry. The Association represents its members on both domestic and international aspects of this business, and promotes their views to the authorities in the United Kingdom, the European Union, and elsewhere. More information LIBA is available at www.liba.org.uk

PASLA was incorporated in Hong Kong in 1995 and is an association of firms that are active in the business of borrowing and lending securities in Asian markets. It provides an important benefit to Asian securities regulators, stock exchanges and monetary authorities by presenting an industry consensus on issues that affect the development of the securities lending business.

RMA. Founded in 1914, The Risk Management Association is a not-for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk principles in the financial services industry. Headquartered in Philadelphia, Pennsylvania, RMA has 3,000 institutional members that include banks of all sizes as well as nonbank financial institutions. They are represented in the association by 21,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific. RMA's Committee on Securities Lending was formed in 1983. The objective of the committee is to promote sound securities lending practices within its members and the industry.

SIFMA represents the industry which powers the global economy. SIFMA is the single powerful voice for strengthening markets and supporting investors -- the world over. Our dynamic, organization is passionately dedicated to representing more than 650 member firms of all sizes, in all financial markets in the U.S. and around the world. We are committed to enhancing the public's trust and confidence in the markets, delivering an efficient, enhanced member network of access and forward-looking services, as well as premiere educational resources for the professionals in our industry and the investors whom they serve.