ICSA
INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

May 4, 2009

Greg Tanzer
Secretary General
IOSCO
C/Oquendo 12
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Spain

Dear Greg,

Re: Comments on IOSCO's Consultation Report on the Regulation of Short Selling

We are writing on behalf of the members of the Standing Committee on Regulatory Affairs of the International Council of Securities Associations (ICSA) which is composed of the trade associations and self-regulatory associations active in the majority of the world's major securities markets. We would like to thank the members of IOSCO's Task Force on Short Selling for the work that they have done to produce the Consultation Report on the Regulation of Short Selling (hereafter referred to as the "Report"). We welcome the opportunity to comment on the Report.

In general, we strongly support the four principles which are stated and discussed in the Report. We find the report as a whole to be a comprehensive review of the regulatory issues arising from short selling, and the Report will serve to usefully inform regulators' development of a "well structured regulatory framework in the interests of maintaining a fair, orderly, and efficient market".

The Report very usefully includes Appendix II which discusses the various Regulatory Concerns relating to short selling. Perhaps understandably, much of the public discussion heretofore has focused on the potential for abusive short selling based on false rumours. The Report, however, makes clear that there are other concerns regarding disorderly markets and settlement disruption which must be considered. We have been concerned that the almost exclusive public focus on abusive short selling has perhaps contributed to a public misimpression that short selling is abusive per se.

Appendix III is very useful in that it explains what a short sale is by illuminating who may be said to own a security. Appendix IV is a very useful survey of the current regulatory approaches to short selling in several jurisdictions which will assist in the reach for greater international consistency of regulation.

Before commenting in detail on the four principles, we would like to emphasize the following some general views that hopefully will be taken into account by the regulators when implementing rules.

1. There is no reason to ban short selling under normal market conditions

We certainly agree with the Report's view that short selling plays an important role in the market for a variety of reasons, including the provision of more efficient price discovery, mitigation of market bubbles, an increase in market liquidity, and the facilitation of hedging and other risk management activities. However, the Report does not include either a statement in favor of short selling in non-chaotic markets in developed, liquid markets with strong infrastructures in place, nor does it include a statement discouraging a ban where the above circumstances are in place. The Report also notes that there is no intention to suggest or recommend that short selling be permitted in all jurisdictions since each market authority must decide the issue in view of its domestic capital market development. Putting these statements together, we would suggest that the Report indicate that in mature liquid markets with adequate infrastructure, permanent bans of short selling appear to be disadvantageous to the market and that the domestic regulator must itself determine the state of its market.

2. This does not mean that the regulators do not have the power (as in September 2008) to put in place emergency temporary measures when necessary.

This power should be exercised on a sound regulatory basis which includes articulated pre-conditions for use of the power.

We need regulatory consistency and proportionality.

This is particularly evident within the European Community which has put in place a single financial market. The temporary measures put in place in September 2008 demonstrated the substantially heightened costs and complexity of implementing differing regimes among Member States. The complexity led to lack of clarity and a less accurate disclosure result. Systems development for disclosures was inordinately challenged by the need to accommodate differing regimes.

3. Settlement discipline is a crucial issue

Whatever the definition of short selling, the key measure to prevent market abuse and disorderly markets is a robust settlement system.

Effective regulation should focus on creating, and enforcing, effective sanctions for failure to deliver on settlement date or within a reasonable period thereafter as set out in the rules. The rules should include a valid defense for a seller who provides convincing evidence of timely good faith efforts to settle a transaction.

Robust settlement procedures would allow a short seller to make arrangements for timely delivery after a short sale and before settlement date. Any failure to arrange settlement can be addressed through harmonized buy-in procedures or proportionate penalty policies.

4. We are not against disclosure to regulators.

We recognize that better information to regulators could be useful in order to help them to better control the proper functioning of the market and to discipline market participants who deliberately fail to settle in due time.

We are in favor of the disclosure of significant individual short positions to the regulators.

5. We question the utility of public disclosure of individual short positions.

Today, there is no evidence that a disclosure of an individual investor's short positions would be useful to the market. We believe that such a disclosure regime would be very difficult to execute and could be very inefficient, and possibly even misleading to the market. Further, the disclosure of short positions would expose market intermediaries and institutional investors to increased trading risk by tipping their positions to market counterparties and institutional traders

If, however, public disclosure is deemed necessary, we believe that any such disclosure should be done on an aggregate, anonymous basis.

Please find below a discussion of the principles set out in the Report.

We think that the foundations for our suggestions lie in the Report itself. We would hope that the proposed calls for proportionality and consistency of regulation will qualify one another and lead to a better and more effective global regulatory posture.

<u>First Principle</u>

The First Principle recognizes the need for strong infrastructure as it calls for "appropriate controls" to reduce or minimize the potential risks of short selling. We note that the Report indicates that the primary objective of such regulation is to reduce the destabilizing effect that short selling can cause "without exerting undue impact on securities lending, hedging, and other types of transactions that are critical to capital formation and to reducing volatility …". The Report states further: "Consideration must also be given to the balance between costs of compliance for market users and providing timely and useful information…" The Report specifically recognizes that "introducing some of these measures (such as price restriction rules or "flagging short sales') in some jurisdictions may be operationally difficult and involve prohibitive costs for the

regulators and the market participants." We propose that the First Principle be amended to read "Short selling should be subject to appropriate, proportionate controls …" In this way, the Principle will explicitly convey the need for appropriate controls which make sense under a cost/benefit analysis. It is important that the First Principal includes an overt reference to this discipline.

Second Principle

The Second Principle provides that short selling should be subject to a reporting regime which provides timely information to the market or to market authorities, but the Report goes on to state that the Technical Committee believes that an "enhanced" and meaningful reporting system is one pillar of an effective regulatory scheme. We are concerned that the call for "enhanced" reporting is unclear because it does not state a reference point. For example, should the US system which requests bi-monthly reporting of aggregate short positions be enhanced? Or should jurisdictions with fewer regulations be enhanced? We propose that "appropriate" be substituted for "enhanced".

Sections 3.20 through 3.22 may be read as an encouragement for all regulators to adopt the full menu of the listed regulatory approaches to meet the cumulative objectives set out in 3.20.1 – 3.20.5. Flagging would address 3.20.5, but flagging in most jurisdictions would be complex and extremely costly. Circuit breakers would answer Section 3.20.3, but they may be impractical in jurisdiction where there has been fragmentation of trading venues as encouraged by regulatory design to create competition. Thus, we suggest that the section on "Objectives of reporting on short sales" include a paragraph which indicates the possibility that regulators may decide to opt for a disclosure regime which does not include all possible measures in favour of a modified system which meets it markets' perceived needs. For example, position reporting at defined trigger levels to the Regulator (not public disclosure) with public disclosure of aggregate reported market short position by the Regulator (disclosures aggregated by an RIS or by the regulator). This would not require flagging but would provide information useful for each of the purposes described in 3.20.1 – 3.20.5. In our view, the public and the market would be most interested in aggregate numbers while the Regulator will be most interested in individual positions.

We also would propose that the text of the Second Principle be amended to refer to a "proportionate reporting regime" which would emphasize the importance of considering the costs as well as benefits of each part of a short selling regime.

Third Principle

The Third Principle is supported by ICSA members, who endorse measures to create an effective compliance and enforcement system. In our view a proportionately rigorous settlement discipline is a key element in identifying developing problems. We also note the importance of securities-lending in facilitating settlements generally. In some jurisdictions, there has recently been some official pressure to restrain stock lending/borrowing in order to curtail short selling. It would be helpful if the report would underline the general importance of stock lending as a liquidity multiplier and the advisability of removing obstacles and unnecessary charges on this activity (taxes, etc).

We propose that the text of the Third Principle refer to a "proportionate and effective compliance and enforcement system". This is to explicitly emphasize the risk that overly constrictive settlement rules could adversely affect liquidity and the costs of trading as indicated in the Report.

Fourth Principle

The Fourth Principle in favor of appropriate exemptions is strongly supported by ICSA.

There is no doubt that the activities mentioned in Section 3.38 are beneficial for efficient market functioning and development and therefore should qualify for appropriate exemption rules. However, since market structures differ and "market makers" in the original narrow technical interpretation of the term do not exist in all markets, it should be clarified that a wider interpretation of market maker is intended which focuses on firms conducting a liquidity providing function denoted by their availability to enter into transactions with market participants on a continuous basis as part of the price discovery process.

We would also propose augmenting Section 3.38 by citing the bona-fide hedging activities of underwriters and sub-underwriters which mitigate risk and result in lower issuance costs accordingly. We believe that the role of underwriters and sub-underwriters is analogous to that of market makers in the sense that they are bringing a security to the public market in a client serving capacity as opposed to trading securities in a proprietary way. Their hedging activities are not for the purpose of making trading profits. We therefore propose that IOSCO add a new category to Paragraph 3 of Appendix III as follows:

(vii) underwriters/sub-underwriters with a long economic interest in securities being offered to the public.

Such would remove hedging activities by these parties from the category of short sales insofar as the sales do not exceed the party's underwriting commitments.

International Consistency of Regulation

The Report states the Technical Committee's hope is that the Report will help to achieve a more internationally consistent regulatory approach to the regulation of short selling. The Report explains that a more consistent approach will help to simplify the compliance process for multinational market participants and to limit potential regulatory arbitrage.

Appendix IV is a comprehensive table of short selling regulation across eight jurisdictions. Paragraph 3.8 et sequitur constitutes a menu of existing regulatory provisions from many countries along with observations that there is the potential for regulations to raise the cost of trading and that all regulations are not appropriate for all jurisdictions. Section 3.20 et sequitur sets out a number of possible objectives of regulatory policy and Section 3.22 indicates that a national authority seeking a comprehensive reporting regime may choose to adopt both flagging and disclosure of short positions. In these sections there is no mention of the need to seek a consistent and proportionate approach. We suggest that there be a discussion of the paucity of established cases of abusive short selling in some jurisdictions and the commissioned studies of the observed effects of recent bans and reporting requirements on volatility, spreads, and price declines in Europe and Hong Kong.

We propose that the need for greater international consistency of proportionate regulation be elevated from a hope to a goal in itself. The Report could also discuss how to move closer to the goal by adopting a modified regulatory regime as discussed with respect to the Second Principle. Proportionality is key in our view and is as important as consistency.

We again thank you for the opportunity to comment on the Report. Please do not hesitate to call upon ISCA if we can be of further assistance in this context.

Yours sincerely,

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