LIBA
LONDON INVESTMENT BANKING ASSOCIATION

SIFMA
Securities Industry and Financial Markets Association

ISDA
International Swaps and Derivatives Association, Inc

ISLA
INTERNATIONAL SECURITIES LENDING ASSOCIATION

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Financial Services Authority
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24 April 2009

Dear Don

Re: Discussion Paper 09/1 – Short Selling

This is a joint response to the Discussion Paper 09/1 on Short Selling (the DP) and is being made on behalf of LIBA, SIFMA, ISDA and ISLA. Information on each of the respondents is provided in the attached Annex 2.

We have given answers to the specific questions posed in the DP which may be found in the attached Annex 1. In addition, we have a number of overarching comments relating to the need for a more internationally consistent approach to the regulation of short selling and the need for such regulation to have clear objectives that are proportionate to the costs of achieving them.

We note that, since the issuance of the DP, a number of national and international regulatory bodies have issued consultations on the regulation of short selling. These include a Consultation Report on the Regulation of Short Selling published by the Technical Committee of the International Organisation of Securities Commissions (the IOSCO Report) and a consultation paper on short selling regime by the Autorite des Marches Financiers (the AMF consultation). In the US, the Securities and Exchange Commission (SEC) have issued a request for comment on potential short sale price test restrictions.

While there is some common ground on a number of the substantive issues, the above and other ongoing consultations also set out proposals for short selling regulation that are often materially different. We recognise that some differences in approach may at least in the short term be unavoidable given differences in domestic factors. However, in view of the global nature of the issue, we would urge all public policy makers to pursue a more internationally consistent approach. This is encouraged by the IOSCO Report in order to reduce the complexity and cost of compliance and to limit regulatory arbitrage.

For example, the AFM consultation appears in many respects to go well beyond the proposals in the DP. It does not recommend a ban on short selling per se, but it does propose a series of regulations without any stated exemptions which cumulatively may disincent legitimate short selling. The proposals include investor disclosure of short positions at a trigger level, flagging of short sales, and reporting by intermediaries of clients' short positions. They include proposals to require "locating" securities to be borrowed before selling short as well as mandatory buy-ins at T+5 instead of T+10. Finally, it proposes that securities borrowers/lenders disclose their transactions and their "prices" to the regulator. While these proposals may result in a regime that is in some ways appropriate to the French market, the consultation underlines the need to balance local factors against the need for a more internationally consistent approach by regulators. For example, all jurisdictions should allow appropriate exemptions for market making and hedging activities as recognised in the IOSCO Report.

Another over-arching concern of our members is that the costs/complexities of any disclosure regime must be proportionate to any benefits of the regime. For example, the IOSCO Report recognises that "flagging" may represent prohibitive costs for regulators and market participants and that all of its proposals may not be suitable for universal application. In contrast, the AMF appears to adopt a less considered approach to the extent that it wonders (e.g. in the context of settlement discipline) whether stricter measures can be envisioned. In this respect, we welcome the FSA approach which follows more closely the suggestion of the IOSCO Report that regulators must be clear about what they want or expect to achieve in establishing a transparency regime for short selling and how it may be most effectively achieved.

In closing, we note that we would welcome the opportunity to discuss the issues raised in the DP and by our response, if that would be useful.

Thank you for framing the issues around the regulation of short selling as well as the opportunity to comment on them.

Yours sincerely

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ANNEX 1

RESPONSES TO DP 09/1 SHORT SELLING QUESTIONS

Q1: ***What are your views on the costs and benefits of a blanket short selling ban? Where possible please quantify. (Page 16).***

Based on the analysis made to date, we agree that the costs of a blanket ban on short selling would outweigh the benefits, if any, of such a measure. The benefits of short selling and thus costs of a ban are clear. The IOSCO Report lists the benefits of short selling as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, and facilitating hedging and other risk management activities. In terms of negative impact, we note that neither the FSA DP nor the IOSCO Report makes the case that there can be a severe negative impact on the market caused by short selling in the absence of market abuse. Moreover, in cases where short-selling could be used (together with other activities) to commit market abuse, it is our view that the market abuse regime exists and is adequate to deter and punish market manipulation. However, as our answer to Q7 indicates, the possibility exists that in extreme market conditions certain non-abusive trading patterns can be seriously damaging. It is for this reason that we suggest that any regulation of short selling be framed under the FSA's responsibility to maintain fair and orderly markets.

We also note that studies commissioned by ISLA/AIMA/LIBA (Cass Business School) and by the London Stock Exchange both point to the negative impact of the short selling ban on the markets for the affected securities i.e. higher volatility, steeper price declines and wider spreads. These seem to be at odds with paragraph 4.7 of the DP describing the results of the FSA's statistical analysis. The Cass Business School and LSE analyses are all based on limited samples and are not free from distortion, but we do not consider that the risk of any deleterious impact caused by short sale bans has been shown to be de minimis or acceptable in normal conditions.

Q2: ***Do you agree that there should not be a ban on all forms of short selling? (Page 17).***

Based on our response to Q1, we agree there should not be a ban on all forms of short selling.

Q3: ***Do you think any further measures are necessary to deal with naked short selling. If so, what is required and why? (Page 18).***

We think that "naked" short sales are effectively constrained in the UK via the strict settlement procedures and effective buy-in policies which operate to enforce timely settlement. These provisions practically frustrate intentionally selling short and failing to deliver on a timely basis. It should also be noted that there has been no showing of any market failure in the settlement posture of UK markets due to short selling. Further measures (such as requiring short sellers to own or have borrowed securities *before* the short sale) are therefore unnecessary. Such measures would moreover have severe unintended consequences (e.g. negatively impacting the efficient use of capital, hindering the liquidity of the stock loan market by encouraging over-borrowing etc) and would furthermore add a friction to securities trading that would ultimately raise trading costs for investors.

Q4: ***Should short selling of financial sector stocks be banned permanently? (Page 18)***

Short selling of financial (and other UK) stocks should not be banned permanently. As outlined in our response to Q1, the consequential costs of a less efficient price formation process are substantial and there is no showing of any material benefit from such a ban..

Q5: ***Do you agree that, subject to having a satisfactory disclosure regime, we should not ban short selling of the stocks of companies engaging in rights issues? (Page 18)***

We agree there should not be a ban on short selling shares of companies during their rights issue process. We are not, in principle, opposed to the disclosure of certain short sale activity to regulatory authorities, however believe it should be balanced and that there should not be disclosure to the public. These views are set fourth in our responses to Q11-21 we set out our views on the content of an appropriate disclosure regime.

Q6: ***Do you agree that we should not ban short selling by underwriters of rights issues (of the shares they are underwriting for the duration of the underwriting process)? (Page 20).***

We agree. We believe that banning short selling by underwriters of rights issues could have a substantial negative impact on the ability for underwriters to manage offerings, and in turn impede the ability for issuers to raise capital, by limiting the number and scope of investors who may participate in offerings. We note that short sales in connection with an 'overallotment,' as well as sales effected to hedge potential risks associated with long positions, are an integral part of the capital raising process for many issuers. Among other things, such syndicate short positions and other hedge positions help to facilitate demand for securities offerings, thus directly benefitting issuers and their shareholders.

The SEC has recognized these benefits, and has adopted exceptions from various short sale regulations for short sales effected by underwriters in connection with offerings. This includes exceptions from 'uptick' rules (both previous and proposed modifications thereto) and an exception for syndicate short positions from the requirement for a person to "borrow or arrange to borrow" prior to effecting short sales, as well as from the "close-out" requirement for fails to deliver occurring in connection with syndicate short positions.

Moreover, in terms of economic interests, an underwriter is "flat" with no long or short exposure when hedged, and thus any "short" sales should have no potential for manipulative or damaging effects on the price of a security. Indeed, our view is that a sale of shares to hedge an underwriters/sub-underwriters' commitment is not a short sale because it is offset by the underwriter's/sub-underwriter's long exposure. On this basis our members' view is that underwriters/sub-underwriters should not be required to publicly disclose sales of securities up to a quantity not exceeding their underwriting commitments, while private disclosure to the relevant issuer would be a matter of contract between the issuer and the underwriters.

Our view is that the underwriting process must be flexible enough to permit issuers and their advisors to shape an offering in the way most likely to attract strong underwriting support which may be difficult in some liquidity/credit environments such as the current environment. Our members are experiencing a diminution of willing capital resources for the capital raising process, and sub-underwriting capacity in particular is being eroded or threatened. Any measures which may be perceived as increasing risk for underwriters or sub-underwriters could affect the viability of the capital raising process. At this time especially, issuers must be in a position to assess the best way forward with their advisors, taking into account their duties to shareholders.

We note that one of the four principles discussed in the IOSCO Report is that short selling regulation should allow appropriate exceptions for certain types of transactions to ensure "efficient market functioning and development". It suggests that hedging as well as market making and arbitraging are activities which should be exempted from regulations. Thus, hedging activities of underwriters and sub-underwriters should be exempted to ensure efficient capital raising for the issuance of securities. Requiring public disclosure of hedging activities by underwriters/sub-underwriters will unnecessarily constrain the availability of capital for this purpose.

Q7: ***Should we intervene to ban short selling on an emergency basis where necessary e.g. to combat market abuse and/or to maintain orderly markets? (Page 20).***

In our view, the evidence and analysis provided to date does not support the need for a power to ban short selling on an emergency basis. We believe that the existing market abuse regime (especially when coupled with appropriate disclosure requirements) renders such a power unnecessary. Moreover, the current evidence demonstrates that such a ban would be damaging to market efficiency. For example, the increased market volatility and decreased trading volume during the pendency of the SEC Emergency Short Sale Ban in September 2008, demonstrate that this type of emergency intervention can have significant adverse impact on market efficiencies. The SEC has been on record themselves indicating that the Emergency Short Sale ban was not the proper approach and had a number of negative consequences.

Nevertheless, if the FSA can substantiate its statement in paragraph 4.24 of the DP by clearly articulating the circumstances where the costs and risks of *not* intervening would indeed 'far outweigh' the potential adverse effect on market efficiency, a decision by the FSA to institute a short sale ban that (i) is narrowly tailored to address those specific circumstances cited by FSA as necessitating such action and (ii) contains appropriate exemptions so as to permit continued short selling that was otherwise beneficial to the market would be proportionate.

We believe that the determination of the circumstances justifying an emergency ban should be as objective as possible, such as measurements of volatility and volume. However, it may be necessary to also use a subjective metric which is suitably qualified e.g. when in the FSA's judgment the market in a particular sector(s) is so disorderly as to substantially impair the viability of the sector(s), the FSA may make binding rules governing short selling of shares in the relevant sector(s). This would accommodate the circumstance where the viability of the banking sector could be threatened as occurred in the FSA's judgment in 2008.

Paragraph 4.23 in the DP refers to a listed issuer's increased vulnerability to false rumours and market manipulation in times of extreme market stress, but the market abuse regime exists to discourage and penalize such behaviour. However, it is also true that such times may witness extreme but legitimate levels of sales of affected shares as long investors "flee to safety" as well as legitimate speculation by short sellers that share prices will fall. If a disclosure regime for short selling is in place and captures daily short position levels, it would be possible for the FSA to determine when the level of short selling rises substantially which could be one metric used to determine whether an emergency situation exists.

Q8: ***Do you agree that no additional circuit-breakers should be introduced? (Page 21)***

In our view, the evidence and analysis provided to date would not support the introduction of additional circuit-breakers.

Q9: ***Do you agree that we should not introduce a tick rule? (Page 22)***

In our view, the evidence and analysis provided to date would not support the introduction of a tick rule. Such a rule would be impractical in the UK because there is no consolidated tape and it would be extremely costly to create one. Moreover, sales are not required to be marked 'long' or 'short' in the UK, thus impacting the practical ability to comply with a tick rules. We are aware that the Securities and Exchange Commission (SEC) is currently (re)consulting on potential short sale price test restrictions and we plan to comment thereon informed by our re-examination of the issue.

Q10: ***Are there any other direct constraints on short selling that you think ought to be considered? If so, please provide information regarding their costs and benefits. Page 22)***

We do not advocate any other form of restrictions on short selling.

Q11: ***Do you agree, in principle, that the benefits of transparency around short selling outweigh the costs? (Page 26)***

We believe that any benefits of transparency will depend entirely on the requirements of the disclosure regime. We recommend that the potential benefits and costs be thoroughly studied prior to implementing such a regime. In this context, we believe any requirement for public disclosure of individual positions will have a significant negative impact on market efficiency and weigh against any benefits of transparency. If a disclosure regime is implemented this should be limited to disclosure of the market's aggregate short positions. If investors were to disclose their positions to the FSA to be aggregated for disclosure to the market as well as for the FSA's ongoing market surveillance purposes, the benefits of the regime would be substantially increased. Alternatively, if the aggregation process is deemed to costly to the FSA, it may be possible to augment the disclosure of open stock loan interest by Euroclear and to make it more timely, since it serves as a proxy for open short positions.

A very important factor in considering the costs of a disclosure regime will be the level of consistency across the EEA and globally. If differing requirements are implemented by various regulators, the costs and disadvantages to market participants will be disproportionate and substantial.

As a predicate point regarding short sale disclosure, and in particular with respect to Q15, we believe that disclosures made under any such regime should be non-public, and only be available for the use of regulators. This is the approach currently taken by the SEC in connection with its short sale and short position reporting rule, Rule 10a-3T. As indicated in our response to Q15, among the potential harm to investors that disclose under a public disclosure regime are the disclosure of information that opens them up to being picked off by other market participants, as well as disclosing part of their proprietary trading strategies.

Q12: ***If disclosure obligations are introduced, do you agree that those obligations should apply to all equities and their related instruments rather than be limited to certain sectors or companies?***

We do not support a disclosure obligation which would apply to all UK equities and non-UK equities which may be traded in the UK. Our members are concerned that a universal regime for disclosure covering all equities traded in the UK would be too burdensome and costly and would not provide beneficial information to the FSA or public because of the magnitude of the data that would be imparted. In addition, such disclosure would take more time to consolidate which would decrease any benefits of disclosure. Collective investment schemes such as ETFs would also make a universal regime too cumbersome. Careful thought should be given to the scope of any disclosure regime while taking into account the need for a consistent approach internationally. We note that for some investors the effort of monitoring and disclosing relevant short positions involves significant manual processing and that sufficient lead time (12 months or more) will be necessary to implement a disclosure regime due to the number of needed changes in the regulatory pipeline and the reduced human and financial resources available.

Q13: ***Do you agree that the disclosure obligations should be limited to the stocks and related instruments of UK issuers? (Page 26)***

We agree that disclosure requirements should not apply to non-UK stocks, but we request clarification of the term "related instruments". We believe that the benefits of extending short position disclosure requirements beyond shares are unlikely to outweigh the costs of doing so given the limited impact of short sales in such instruments on the underlying stock price. We reiterate that consistency of such obligations across jurisdictions is very important.

Q14: ***Do you agree that the costs of introducing a regime based on disclosure of aggregate short positions would outweigh the benefits? (Page 28)***

We agree that the costs of a system based on flagging every short sale would outweigh the benefits of such a system. However, if the FSA would be aggregating the individual disclosures of investors meeting the trigger levels for its own purposes, it could be advantageous to disclose the aggregate of reported (significant) short positions to the market as an indicator of short selling activity.

Q15: ***Do you agree that benefits of public disclosure of significant short positions outweigh the costs? (Page 30)***

We fundamentally question whether public disclosure of short positions by individual investors is justified given the potentially harmful effects on those who disclose their short positions as well as the potential for "herding" into short positions. It is also likely that the level of legitimate short sales will be reduced which will affect price discovery. Para 5.32 and 5.33 give rather brief treatment to exploring any alternative method of aggregate disclosure. It would be useful to consider any middle way in terms of stated purposes of the disclosure regime.

Q16: ***Do you agree that an individual significant short position disclosure regime should be on a net basis? (Page 30)***

We agree disclosure of short positions on a net basis is most appropriate. We propose that corporate disclosures be made on a group (legal entity?) basis.

Q17: ***Do you agree that 0.50% would be an appropriate threshold for triggering disclosures under a net short position regime? If not, what alternative would you propose and what are your reasons for this figure? (Page 32)***

An initial disclosure trigger of 0.5% would be more appropriate than a trigger of 0.25%.

Q18: ***Do you agree that a banded approach to disclosure should apply in conjunction with a minimum threshold? If so, do you agree that such a banded approach should be based on bands of 0.10% of a company's issued share capital? (Page 32)***

A banded approach to subsequent disclosure seems workable/advisable. However, we would suggest broader bands at 0.5% increments. This would be more proportionate without materially reducing the regime's putative usefulness to certain market participants.

Q19: ***If long-term disclosure obligations are introduced, do you agree that market makers should be exempt from those obligations when they are acting in the capacity of a market maker? Do you also agree that this should be an absolute exemption? (Page 33)***

We strongly agree that market makers acting as market makers should be exempted from short disclosure requirements and that there should be a wide definition of market maker for these purposes. We would propose that the definition currently applied for the disclosure regime be made part of the FSA handbook. It is most important that there be consistency at least among EEA states, if not globally, on the exemption and its breadth.

Q20: ***Do you agree that maintaining the current disclosure obligation of 0.25% of a company's issued share capital for rights issue situations is appropriate? (Page 35)***

We do not agree that the disclosure regime for rights issues should differ from the general disclosure regime for reasons of cost and complexity.

We propose that the disclosure trigger during rights offerings be the same as for the general regime i.e. 0.5%. and that scope of the regime be made uniform (only UK companies rights issues) so that it is no longer necessary to track which issuers are conducting rights issues. If the regimes are not homogenized, we would ask that the FSA publish a daily list of shares undergoing a rights offering.

Q21: ***Do you agree that the on going disclosure obligations should be the same as the general regime? (Page 35)***

Yes – we would wish to avoid inconsistent disclosure triggers to avoid undue complexity and costs.

Q22: ***Do you consider that any further measures are necessary in respect of CDS? (Page 25)***

We do not consider that further measures in respect of CDS have been shown to be necessary at this time.

ANNEX 2

About our associations:

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

SIFMA brings together the shared interests of more than 650 securities firms, banks, investors, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in London, New York, Washington DC, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong More information about SIFMA is available at www.sifma.org.

ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org

ISLA represents the common interests of nearly one hundred borrowers and lenders of securities in Europe, Asia and the Middle East. While based in London, it has members in more than twenty countries. More information is available at www.isla.co.uk.