CONSULTATION ON SHORT SELLING

1. The International Securities Lending Association (ISLA) welcomes the public consultation by CONSOB on resolution no. 16765 of 30 December 2008.

2. We have attached ISLA's response to the parallel CESR consultation on short selling measures, which gives our views on regulation of short selling more generally. ISLA supports harmonisation of regulatory approaches in Europe and internationally.

3. We would like to comment on one particular aspect of the CONSOB regulation. This is the requirement to instruct a recall of lent securities, if necessary, on the same day as any sale of those securities by the investor.

4. *In our opinion, sales of securities that are on loan should not be regarded as 'short' sales because they do not put the investor in an economic short position – it does not benefit if the price of the shares falls.* Although legal title to the security is transferred to the borrower in a securities lending transaction, economic ownership remains with the lender. The lender remains exposed to all price risk on the securities. Payments equivalent to all dividends and other cashflows on the securities are made by the borrower to the lender. The lender can recall the lent securities in time to settle any sale. Reflecting this position, the accounting treatment of a securities loan for a lender is to keep the lent securities on balance sheet. Nearly all other EU regulators take the view that sales of lent securities are not short sales. We believe that any regulatory requirements should focus on encouraging timely settlement and preventing persistent fails.

5. *If CONSOB maintains the requirement that lent securities must be recalled, if necessary, within a defined period of time following a sale, we would ask that this window be extended to include the business day following the trade date (t+1).* Securities lending is often managed independently from investment management by an investor's custodian bank or a third party lending agent. Securities lending transactions are designed so that, if necessary, the lending agent can recall the securities from the borrower in time to settle an outright sale. But the lending agent will be unaware of any sale and not in a position to issue a recall instruction until it receives a report from the investment manager after the transaction. This post-trade reporting is typically a highly-automated, well-established process eg via SWIFT, with agent lenders receiving reports on the day of the trade or the following day (eg in the case of late-in-the-day trades or trades in later time zones). Investment managers will not pre-advise the lending agent because this would delay the sale unacceptably and also risk knowledge of it leaking into the market with a possible adverse price impact.

6. The lending agent then takes the following actions in order to ensure that securities are available to settle the trade (in order of preference) (i) sees whether sufficient unlent securities are available on the relevant account; or (ii) sees whether lent securities can be released by reallocating loans to another client that has those shares available to lend and is also willing to trade with that borrower; or (iii) recalls securities from the borrower. Any recall instruction will therefore necessarily follow the sale order chronologically (typically on the following business day) but the securities can nonetheless be returned in time to settle the sale. Requiring a recall instruction to be issued on the day of sale makes it difficult to operate an agent lending programme in practice.

7. We would like to thank you for the opportunity to send in our comments and would be happy to discuss any questions you may have.

About ISLA 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.

International Securities Lending Association
January 2009

RESPONSE OF INTERNATIONAL SECURITIES LENDING ASSOCIATION TO CALL FOR EVIDENCE BY CESR ON REGULATION OF SHORT SELLING

1. We would like to thank CESR for the opportunity to provide our members' views on the regulation of short selling.

2. The CESR notice asked two specific questions, on which we have given views below. You should be aware that we have already expressed the same views in a joint letter with the Pan-Asia Securities Lending Association and the Securities Industry and Financial Markets Association dated 23 December sent to Martin Wheatley, chair of the Short Selling task force of the IOSCO Technical Committee. ISLA supports international harmonization of any regulation of short selling, both within Europe and globally, and encourages CESR to coordinate with work of the IOSCO group.

Question 1: What practical issues have arisen as a result of the temporary measures to restrict short selling introduced since September?

3. In our view, the restrictions on short selling introduced since September have had little or no effect on share price returns. But they have impaired market efficiency, reduced liquidity, raised trading costs for investors, and created compliance costs for market participants. In addition, particular measures in some countries have caused practical difficulties for securities lenders and their agents.

4. *Little or no effect on share price returns*. Together with the London Investment Banking Association and the Alternative Investment Management Association, ISLA commissioned independent academic research by Professor Ian Marsh of Cass Business School to examine whether the short selling restrictions introduced in various countries in September had had any effect on share price returns. The research paper can be found at http://www.cass.city.ac.uk/media/stories/resources/the-impact-ofshort-sales-restrictions.pdf.

5. The main findings were:

- No strong evidence that restrictions on short selling changed the behaviour of stock returns. Stocks subject to the restrictions behaved very similarly both to how they behaved before their imposition and to how stocks not subject to the restrictions behaved.
- Comparing behaviour across countries where the nature of the restrictions differed, no systematic patterns consistent with the expected effect of the new regulations, i.e. no evidence of a reduced probability of large price falls.
- Regression analysis suggested that changes in stock returns were driven mainly by other factors affecting the financial sector as a whole rather than the restrictions on short selling. That is, some systematic changes in the behaviour of financial sector stocks could be discerned, but no strong evidence of a systematic impact of the restrictions could be identified.

6. *Impaired market efficiency, reduced liquidity and raised trading costs*. Research by the London Stock Exchange[1] has found that liquidity in the restricted UK bank and financial stocks fell and trading costs rose following the introduction of short selling restrictions. Similar results have been found in the US market following the introduction of short selling restrictions there.

7. The main findings of the London Stock Exchange report were that, comparing restricted stocks (ie bank and financials) to a control group of unrestricted stocks:

- The widening of bid:offer spreads was 150% greater;
- The decrease in depth on the order book was 37% greater;
- Trade and volume fell by approximately 10% whereas it rose for unrestricted stocks;
- Turnover fell by 21% whereas it rose for unrestricted stocks.

8. Results of two separate regression analyses showed that the observed decline in liquidity occurred independently of market-wide changes and increased volatility, respectively. The models are economically and statistically significant and suggest that

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[1] See http://www.londonstockexchange.com/NR/rdonlyres/5EDD66EF-B589-4974-95B1-73C51F1C9DFC/0/ShortsellingRestrictionsandMarketQualityDecember2008.pdf

banned stocks in the post-ban period had lower liquidity compared to the control sample and after controlling for market-wide variables.

9. *Compliance costs*. Restrictions were introduced in many countries worldwide, without consultation or notice. The restrictions differed between countries and were frequently unclear or not fully specified, requiring subsequent clarifications. Compliance costs for financial firms have been significant at a time when they are facing many other pressures. These costs are difficult to measure because they have generally had the effect of occupying existing staff, often at a relatively senior level, rather than requiring the hiring of new staff or IT expenditure.

10. *Particular practical difficulties for securities lenders and their agents*. In France and Belgium, securities lenders have been asked to refrain from lending except for certain purposes, defined by the regulator. Compliance with this request has been difficult given the need to investigate the purpose for which securities are being borrowed, usually complicated by the fact that securities are often borrowed in a chain involving a number of intermediaries.

11. In Italy and Spain, the interpretation that sales of lent shares will be treated as naked short sales has caused difficulties for agent lenders. We would urge that any definition of naked short selling exclude sales where securities are currently on loan. First, such sales do not put the investor in an economic short position. Second, securities lending is often managed independently from investment management by an investor's custodian bank or a third party lending agent. Securities lending transactions are designed so that, if necessary, the lending agent can recall the securities from the borrower in time to settle an outright sale. But the lending agent will be unaware of any sale and not in a position to issue a recall instruction until it receives a report from the investment manager after the transaction. This post-trade reporting is typically a highly-automated, well-established process, with agent lenders receiving reports on the day of the trade or the following day (eg in the case of late-in-the-day trades or trades in later time zones). Investment managers will not pre-advise the lending agent because this would delay the sale unacceptably and also risk knowledge of it leaking into the market with a possible adverse price impact. Any recall instruction will therefore necessarily follow the sale order chronologically (typically on the following business day) but the securities can

nonetheless be returned in time to settle the sale. Requiring a recall instruction to be issued prior to the sale (ie treating a sale without a prior recall of lent shares as a ‘naked’ short sale) makes it very difficult to operate an agent lending programme in practice.

Question 2: What permanent measures, if any, CESR Members should introduce?

12. ISLA does not believe there is a case for banning short selling, either of all stocks or particular types of stocks. In our view, short selling is a legitimate investment and hedging technique that improves market efficiency and is essential in providing liquidity to the securities markets. We also see no particular reason to restrict short selling at times when companies are raising capital, especially given the need for investors and underwriters to be able to hedge positions in the newly-issued securities.

13. In general, we think that any measures need to be linked directly to regulatory objectives, with a clear legal basis and subject to cost: benefit analysis. Our understanding is that possible regulatory objectives include:

- Preventing so-called ‘abusive’ short selling, perhaps combined with rumour mongering, intended to create artificial downward price movements and leading to share price volatility that threatens fair and orderly markets.
- Providing information to investors about short interest in securities in order to improve market efficiency.
- Ensuring efficient settlement of transactions.

Preventing ‘abusive’ short selling

14. In general, we think ‘abusive’ short selling should be controlled under general market abuse regulations: for example, to prevent spreading of market rumours or trading strategies designed to manipulate market prices.

15. *‘Naked’ short selling*. We agree that short sellers should 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. Adding a requirement to have

borrowed the securities before the sale adds a friction that ultimately raises trading costs for investors.

16. 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. But 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.

17. Although we think it is unnecessary to prohibit naked short selling in order to achieve regulatory objectives, we understand that some regulators have taken a different view and our members would not object strongly to a well-designed ban on naked short selling. However, ensuring that any restrictions are well designed needs careful thought and consultation: for example, with regard to the treatment of physical vs derivatives positions and the scope of the instruments covered eg baskets, indices, exchange-traded funds etc.

18. In particular, we would urge that any definition of naked short selling exclude sales by lenders where securities are currently on loan (see paragraph 11 above).

19. *Tick rules.* We note that the US SEC abolished the uptick rule in July 2007 after more than two years of analysis, having concluded that it brought no net benefit to the market and may in fact reduce market liquidity. We see no reason at this time to change those conclusions. Moreover, implementing a tick rule using a consolidated price feed may be problematic and costly in today's markets, which have seen a welcome proliferation of trading venues in the European Union following the introduction of MiFID.

Providing information to investors about short interest

20. We are not, in principle, opposed to disclosure of short sale activity, including short positions and short transactions. For firms conducting a cross-border business, harmonization of the rules would significantly reduce the costs of compliance in most jurisdictions. We believe, however, 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 need to avoid double counting, sheer volume of data, etc.); and (iii) the cost to institutions of producing the information to multiple regulators.

21. 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.

22. 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 information about the aggregate across all disclosing entities net short position in individual shares. It would, however, be extremely challenging to design a reporting regime that allowed an authority (eg a regulator) to produce reliable aggregate data given the range of instruments (including derivatives) that can be used to take positions and the need to avoid double counting.

23. 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.

24. We assume that confidential disclosure to regulators would be primarily for the purpose of monitoring activity in order to investigate any cases of suspected abusive short selling. To that end, regulators need to consider whether they need periodic reports of short sale activity (ie transactions marked as short sales) from banks and dealers and/or periodic reports on net short positions from a wider range of investors (eg hedge fund managers, investment managers).

25. To get the most accurate set of 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). Quarterly reporting should be adequate to monitor these positions, with an obligation to report triggered on crossing a materiality threshold expressed as a percentage of shares outstanding (eg 5%). Such confidential reporting of individual positions to regulators should be aligned with any reporting used by regulators or other bodies to produce published aggregate short interest statistics.

26. On the basis that disclosure is used by regulators to monitor for abusive short selling and perhaps to calculate aggregate data 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. 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.

Ensuring efficient settlement of transactions

27. 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 3 days) following the settlement date to deliver the securities.

28. An active securities lending market is key to preventing chains of failed trades (as recognised, for example, in the recent draft CESR/ESCB recommendations for securities settlement systems in the European Union). We note that unduly restrictive penalties for failed settlement may deter securities lending if institutional investors have concerns that they may not always be able to recall lent securities in time to meet the settlement timetable.

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29. We would like to thank you again for the opportunity to send in our comments and would be happy to discuss any questions you may have.

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