Public Comment on Regulation of Short Selling[1], submitted by the Hedge Fund Standards Board (HFSB)

Introduction

Short selling plays an important role in global financial markets and brings many benefits to the global economies, including investor protection against market volatility, increased liquidity for all market participants, more efficient price discovery, dampening of price bubbles and prevention of other market inefficiencies, and ultimately more efficient capital allocation.

The ability to sell stocks short makes investing far more attractive at times of stress because it encourages investors to stay in the market even when prices are declining. By hedging their positions through short sales, investors can continue to hold other stocks with the aim of achieving absolute returns. Without the option to short sell, investors are much more likely to withdraw from a declining market, accentuating the market contraction during major crises like the present one.

The recent short selling ban has brought this investment management and hedging instrument to the forefront of the public and regulatory debate. The HFSB is pleased to comment on the IOSCO Consultation Report on the Regulation of Short Selling.

Consultation responses

Before commenting on the four principles set out by IOSCO, HFSB finds it important to highlight that it agrees with the IOSCO assessment of the importance of short selling in markets, notably more efficient price discovery, mitigation of market bubbles, increased market liquidity and facilitation of hedging and other risk management activity.[2]

Notwithstanding these benefits, HFSB is aware that there can be cases of market abuse in the context of short selling. One such activity is called "short and distort", where false rumours are spread causing a stock to fall. This is similar to market abuse activity in the context of long positions such as "pump and dump". All such market manipulation is already illegal for example under current EU legislation (Market Abuse Directive), and the HFSB has set out best practice standards to help hedge fund managers comply with these legal and regulatory requirements.

In the context of "disorderly markets", HFSB would also like to caution regulators' expectations with respect to the effectiveness of market interventions with them aim of restricting short selling. In the context of the recent short selling restrictions, statements by regulators have confirmed that short selling was not seen as the root cause of the crisis, but that falling bank stocks were instead the

[1] Relevant consultation document: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf
[2] Also see HFSB input to the IOSCO short selling taskforce (January 2009), and input to CESR, available at http://www.cesr-eu.org/popup_responses.php?id=4478 , providing an overview on the role of short selling in markets.

consequence of the broader problems in the banking sector and a general loss of confidence which ultimately could only be resolved through massive government intervention. With or without short selling, the public realized that banks were extremely vulnerable, due to their exposure to risky assets far beyond what their reduced levels of equity would support. Since this lack of confidence very quickly led to bank runs and given that several financial institutions filed for bankruptcy, investors shied away from bank stocks for reasons which have no relation to short selling.

HFSB acknowledges that when regulators and politicians are coping with an emergency brought on by fears of a meltdown of the banking system (i.e., a run on the banks caused by plummeting bank stocks), extreme measures may be warranted. In such instances, however, it is important that regulators and politicians assess the adequacy of a specific measure to resolve a given problem ("Does the measure help to restore order to the markets?", "Does the measure prevent bank stocks from falling further?", Does the measure clearly facilitate vital capital raising activities?" or ultimately "Does the measure reduce the probability of a run on the bank?").

Indeed, regulatory intervention interfering with the market and price formation process can have a more devastating impact, since it can give rise to concern by investors about the efficiency of the price formation process, and thereby trigger further sell offs of those who would otherwise hold on to their assets. Also, regulatory interference (eg in relation to short selling) can also implicitly tell the markets that the practice of short selling results in distortions in the price discovery process, and more broadly, that it allowed some market participants to manipulate prices. However, in the context of the recent crisis, we believe that, on the contrary, the price discovery process did function, and that the short selling ban has actually distorted the price discovery process, and that the ban has ultimately undermined confidence in the markets.

Therefore, it is of utmost importance that the regulatory toolkit to be developed in relation to short selling is anchored in a) a rigorous process for identifying disorderly markets, and b) a carefully calibrated spectrum of tools/mitigants regulators can employ to counter disorderly markets (as part of this, restrictions on short selling might be only one of the available tools. We believe that in many instances short selling will not be the cause of disorderly markets).

The reason of this rather rigorous approach is to avoid that regulators ultimately become the source or an amplifier of market disruption and disorder, due to presumably well meant intervention, which ultimately prevents the price formation process from happening (in particular in times of distress).

The first principle: Short selling should be subject to appropriate controls to reduce or minimise the potential risk that could affect the orderly and efficient functioning and stability of financial markets.

HFSB comment:

[3.7, 3.12-3.16] HFSB agrees that the functioning of the settlement process is a key prerequisite for orderly short selling activity. Therefore, HFSB agrees with settlement rules to help achieve this objective. However, it is important to highlight that failed trades constitute a small minority of overall short selling activity, and that any regime, while helping to prevent abuse, should leave sufficient flexibility for markets to operate efficiently.

3.8-3.11 HFSB agrees that with an increasing number and complexity of measures that regulators implement, the cost to those engaging (and enabling) short selling will increase significantly. As highlighted by IOSCO, each of the different detailed measures[3] have different levels of effectiveness (and relevance) to specific markets. Therefore, HFSB does not believe that prescriptive recommendations in respect of each of these measures should be included in the high level recommendations set out by IOSCO, but they could well form part of the toolkit regulators can choose from in their specific local context and in light of their specific concerns. However, it is important to complement the use of such a toolkit with the rigorous assessment mentioned above.

The second principle: Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.

HFSB comment:

Discussion has recently emerged around whether there should be a general disclosure regime around short positions, in particular since several regulators have recently enhanced disclosure requirements in this area.

[3.17] IOSCO highlights that meaningful reporting of short selling is the second pillar of an effective short selling regulatory regime, and recommends that jurisdictions should consider some form of reporting of short selling information to the market and recommends that for those markets where reporting to the markets is considered inappropriate, then, as a minimum requirement, reporting should be made to market authorities.

HFSB has developed a framework to assess the transparency needs in relation to short selling, thereby enabling the design of a meaningful reporting and transparency regime. The objective of the framework is to provide answers to the following questions:

- What is the issue?
- What existing law and regulation is already in place to address the issue?
- Is additional transparency required to address the issue?
- To whom is this information relevant?
- What information is needed? (ie nature, frequency, trigger levels, reporting by whom)
- What are potential mitigants in relation to the issue?
- And what are potential concerns in relation to the mitigants?

This framework is in line with some of the questions highlighted by IOSCO [3.23], and ultimately allows to derive the high level features of a short selling reporting regime which could form the basis for the high level IOSCO recommendations in relation to the second principle [as set out in 3.17]. HFSB believes that once agreement on the answers to these overarching questions has been achieved, it will also be easier, in a second step, to determine some of the more detailed features of any reporting regime in relation to short selling.

The starting point of the analysis are the two major motivations behind additional disclosures of short positions, 1. financial stability, and 2. market integrity/efficiency. The following table provides the required assessment along the questions set out above:

[3] Price restriction rules, pre borrowing requirements, specific eligibility criteria for stocks, price restrictions, flagging to the exchange, margin requirements, mandatory buy-in/close-out to cover failed delivery.

Assessment of short selling disclosure regimes

What is the issue?	What are we seeking to achieve?	What existing law and regulation is in already in place to address the issue?	Is additional transparency required to address the issue?	To whom is this infor-mation relevant?	What information is needed? (ie nature, and frequency, trigger levels, reporting by whom)	What are potential mitigants in relation to the issue?	And what are potential concerns?
Financial Stability	Enabling regulators to spot and counteract risk of disorderly markets and financial instability *[HFSB sees no evidence for disorderly markets caused by short selling]*		- It does not appear that there is a permanent threat to disorderly markets in relation to short selling at all. Indeed, the crisis in fall 2008 has not been caused by short selling. Therefore, it is difficult to build a case for a permanent reporting/transparency regime in relation to short positions. - However, regulators should be in a position to collect relevant data during times of distress. The focus should then lie on systemically relevant sectors (such as banking, insurance).	Only regulators	Nature: Aggregate short position (eg to assess in relation to trading volume). This can be derived from looking at net short positions of relevant market participants. Frequency: Only in times of distress	This is a very sensitive issue, since regulatory intervention can by itself hurt market confidence and thereby actually enhance distress. HFSB has set out a "waterfall approach" (see appendix) that could be drawn upon, but only after careful assessment of the causes of distress (ie is short selling really to blame, or just a symptom of something else?)	- Cost to collect data - Leakage risk of individual positions
Market integrity/ efficiency	-Allowing better price discovery -Allowing transparency for control purposes	-Existing market abuse law - Disclosure and Transparency Rules (for long positions)	Mirroring the long disclosure requirements on the short side.	- All market partici-pants - Regu-lators	*Nature:* Combined short position of shares and instruments (such as CFD) of individual market participants. *Trigger level:* Symmetric to longs, eg 3%, and for	-Enforcement of existing market abuse law and regulation, enforcement of disclosure requirements (such as for example the Disclosure and	-Excessive transparency could alter the risk-reward ratio for short sellers (reducing the price correction

What is the issue?	What are we seeking to achieve?	What existing law and regulation is in already in place to address the issue?	Is additional transparency required to address the issue?	To whom is this infor-mation relevant?	What information is needed? (ie nature, and frequency, trigger levels, reporting by whom)	What are potential mitigants in relation to the issue?	And what are potential concerns?
					each % point thereafter *Frequency:* Whenever a threshold is surpassed	Transparency Rules) -Investigation of settlement failures to detect abusive behaviour	benefit) - Information message from a short sale might be ambiguous (both as per IOSCO paper 3.18.2)

There is one important distinction to highlight regarding the disclosure regimes illustrated above: While for financial stability purposes, the aggregate level of shorts is relevant to regulators, it is the individual manager level disclosure that is relevant in the market efficiency/integrity context to all market participants and regulators . In the latter context, the question arises what should be the adequate disclosure thresholds for individual short positions. The HFSB believes that a symmetric approach is appropriate, mirroring the disclosures required in the context of long positions for the following reasons:

- The market impact of long and short positions is similar;
- Underpriced stocks are equally damaging as overpriced stocks from a market efficiency perspective;
- The risk of market manipulation is equally damaging whether it takes place in the form of long or short positions.

Currently, the long position disclosure regimes vary by country: In the UK, the Disclosure and Transparency Rules require disclosure of the combined long position of shares and CFDs if the 3% threshold is exceeded and for each percentage point thereafter (UK issuers). Beyond establishing a symmetric approach for short disclosures, HFSB would welcome further European/global harmonisation of disclosure mechanisms.

The Third Principle: Short selling should be subject to an effective compliance and enforcement system

HFSB comment:

HFSB agrees that regulators should have tools available to detect abusive behaviour and have enforcement capabilities. In addition, regulators should have powers to collect information to detect and sanction abuse, and many regulators and exchanges already have such powers.

IOSCO highlights the risk of "large open short positions which may pose systemic risk to the market" (3.31). As highlighted above, the HFSB is unsure what constitutes systemic risk in the context of short selling, since there is ultimately always a buyer of the respective shorted security and the borrower will ultimately have to buy back the security in the market to deliver to the lender.

The Fourth Principle: Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

HFSB comment:

The HFSB agrees that flexibility should be build into any regime, in order not to stifle legitimate short selling activity, for example for hedging, arbitrage, as well as market making activities.

Appendix 1: Illustrative overview of waterfall approach to counteract disorderly markets

	Potential measures
Stage 1	• Short selling restrictions during rights issuance periods of banks (eg lowered disclosure threshold)
Stage 2	• Banning of uncovered/naked shorting
Stage 3	• Enhanced disclosures (aggregate disclosure to regulators)
Stage 4	• Uptick rule
Stage 5	• Banning of covered shorting
Stage 6	• Suspending stocks from trading /closing a market