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Mr. Greg Tanzer
Secretary General
IOSCO
C / Oquendo 12
28006 Madrid
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Brussels, 4 May 2009

Dear Mr. Tanzer,

Re: FESE Public Comment on Regulation of Short-Selling

The Federation of European Securities Exchanges (FESE) represents the Market Operators of 42 securities exchanges active in equities, bonds, and derivatives in the European Union (EU) and Iceland, Norway and Switzerland. We welcome the work that the IOSCO Technical Committee has carried out on short-selling to address the concerns that emerged during the crisis. We appreciate the rationale behind the measures taken by several authorities around the globe: extreme market conditions triggered extreme measures to seek to restore confidence in the markets.

Notwithstanding the laudable intentions, the restrictions imposed by several authorities in the EU with regard to short-selling have been both **discriminatory** and **ineffective**:

1) The restrictions on short-selling have been discriminatory because of their scope of instruments and venues. Firstly, in some jurisdictions the short-selling restrictions applied to certain cash equities only and did not cover other instruments that fulfil a similar function in the market (e.g. futures and options that allow investors to profit when the stock or the index declines). Secondly, the restrictions applied only to cash equities admitted to trading on a Regulated Market (RM) and not to privately-issued stocks. Thirdly, in some regimes, the restrictions did not cover trading happening outside of RMs - therefore, the banned stocks could be traded on private markets without limitations.

The discriminatory nature of these measures was mainly due to the absence of an appropriate legislative framework that covers instruments traded in multiple execution venues under the supervision of different authorities across Europe. As a result, this situation provided unfair advantages to private OTC markets vis-à-vis RMs (and MTFs) whilst shifting the presumed risk to other venues and instruments not caught by the ban.

2) The restrictions on short-selling have not been effective in reducing share price volatility or limiting share price falls, but rather caused a decline in market efficiency for the affected stocks. A study[1] of London's Cass Business School which analysed the effects of the bans imposed in several jurisdictions (among which, in the EU, France, Germany, Italy, Sweden and the United Kingdom) and concluded that there is "no strong evidence that the restrictions have been effective in reducing share price volatility or limiting share price falls". Furthermore, the Capital

[1] "The Impact of Short Sales Restrictions" by Ian W. Marsh and Norman Niemer, 30 November 2008.

Markets Cooperative Research Centre Limited study conducted in December 2008[2] (based on statistical analysis on the effect of the prohibition on market quality on the London Stock Exchange) found that the increase in spreads in the banned stocks was 150% greater than the increase in spreads in control stocks and that the deterioration in depth in banned stocks was 37% greater than the deterioration in depth in control stocks. In the banned stocks, trades and volume fell and turnover and liquidity also reduced. Evidence from other markets confirms these findings.

- Proposed Solutions

The beneficial role of short-selling is widely recognised by authorities and the academic literature; its key benefits are beyond question: short-selling increases market liquidity, provides more efficient price discovery and facilitates hedging (and other risk management activities). Market players look to it as an important tool to keep the markets stable. Recently, several institutions (e.g. the IOSCO Technical Committee[3], the SEC[4] and the ECB[5]) acknowledged the positive role played by short-selling.

Given the benefits of short-selling and the inter-connectedness of markets,we are convinced that any proposals that could be considered should be discussed at the international level and endorsed by the relevant stakeholders. Proportionate measures that truly address the policy concerns should be well justified and applied in a non-discriminatory way to <u>all</u> venues and instruments concerned. In the EU, to avoid disruptions to the Single Market, the same principles must apply in all jurisdictions and regulators must act in close coordination. A regulatory framework that allows this kind of coordination would increase the transparency of the market and the protection of investors. Therefore, FESE fully supports the IOSCO's international approach and agrees that a global response can help restore investor confidence in fair, efficient and transparent markets.

The need to base any future rules on a common international understanding of basic principles and technicalities is also highlighted by March 2009 Report[6] by the European Securities Markets Expert Group (ESME), which, at the end of the year 2008, was asked by the European Commission to evaluate certain aspects of short-selling.

We would like to commend the thoroughness of the work undertaken by ESME and express full support in particular for the following three conclusions[7] it has reached:

- *A measure* (e.g. 'Level 3' Guidance) *concerning the* ***disclosure of short-selling activity****, to be achieved on an aggregated and anonymous basis, could provide useful information to both the competent authorities and market participants*. In addition, FESE believes that it would be necessary to discuss whether this measure should be permanent, the scope - in terms of instruments (e.g. the treatment of derivatives) and venues – to which disclosure rules would apply, the threshold for any disclosure requirements, the recipient of the

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[2] "The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange" by Capital Markets Cooperative Research Centre Limited, 19 December 2008.

[3] http://www.fsa.go.jp/inter/ios/20081113/04.pdf

[4] http://www.sec.gov/news/press/2008/2008-235.htm

[5] http://www.ecb.int/pub/pdf/other/ecconsultationhedgefundseurosystemen.pdf

[6] http://ec.europa.eu/internal_market/securities/docs/esme/report_20090319_en.pdf

[7] ESME original wording is in *italic*.

information and the frequency of the reporting requirements. In any case, to allow for a consistent application across the EU, detailed research would be necessary.

- *Any alternative measures should be considered on a cost-benefit basis*; we agree that **rules that might be appropriate for the needs of some markets (e.g. uptick rules, circuit breakers) could be too costly and difficult to implement in other jurisdictions**. Moreover, *their effectiveness has not been proved from a cost-benefit perspective*.

- **Procedures for addressing late settlements** would increase the efficiency of our markets and address potential settlement drawbacks. *Buy-in rules could be considered*.

In any case, short-selling as such should never be banned or limited, no matter what the market conditions might be.

- **Comments on the IOSCO's proposals**

a) Short-selling 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.

FESE fully agrees with the Technical Committee's view that having a robust discipline for settlement of short sales is central to an effective short selling regulatory regime. We support strict regulation for failed trades, as well as a short settlement cycle (T+3) provided it applies to all comparable types of execution venues (including systematic internalisers and broker dealer operated crossing systems). Procedures for addressing late settlements would increase the efficiency of our markets and address potential settlement drawbacks. As a matter of fact, stock exchanges and clearing houses have limited possibility to prevent settlement risk; as short-selling is a service provided by investment firms to their clients, the firms should implement proper internal regulations to ensure sufficient risk management.

Against this background, it is fair to stress that additional measures in force in other jurisdictions outside the EU should not be uniformly imposed on other countries. Rules that are appropriate for the needs of other markets (e.g. uptick rules, "flagging" of trades, circuit breakers) could be too costly and difficult to implement in other jurisdictions.

b) Short-selling should be subject to a reporting regime that provides timely information to the market or to market authorities.

We believe that enhanced and meaningful reporting of short-selling (e.g. volumes and open positions) could be beneficial if transparency measures are well thought through and proportionate. As a general approach, we believe that there should be a distinction between reporting to authorities and reporting to the market; moreover, authorities should be very clear with regard to which objectives a specific measure aims to achieve. Finally, a detailed cost-benefit analysis should be undertaken with clear objectives in mind.

c) Short-selling should be subject to an effective compliance and enforcement system.

We agree that market authorities should regularly monitor and inspect, according to the relevant prescriptions, whether the settlement discipline is working as intended. In this regard, a solution for the harmonisation of individual markets' approach to and control of short-selling would be welcome. However, before creating and managing a central compliance and enforcement system one should consider the costs and benefits

d) Short-selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

We agree with the fourth principle and the assessment that necessary activities like "hedging" or "market-making" – because of the role they play in the market - should be exempted from short-selling regulations.

I hope that our comments will prove helpful to the IOSCO Technical Committee. Please do not hesitate to contact me should you wish to discuss any aspect of this letter.

Yours sincerely,

Judith Hardt

FESE Secretary General

FEDERATION OF EUROPEAN SECURITIES EXCHANGES