REGULATION OF SHORT SELLING

Final Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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FINAL REPORT ON
REGULATION OF SHORT SELLING

1. Executive Summary

1.1 In view of the recent financial crisis, the Technical Committee set up the Task Force on Short Selling (Task Force)[1] to work to eliminate gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions. In this connection, the Task Force also examines how to minimize adverse impacts on legitimate securities lending, hedging and other types of transactions that are critical to capital formation and to reducing market volatility.

1.2 The mandate of the Task Force is to develop high-level principles for the effective regulation of short selling. These principles are designed to assist regulators in their consideration of a regulatory regime for short selling. This international initiative is an important global response which may help restore and maintain investor confidence under the current financial crisis, as the principles are formulated with a view to addressing the objectives of investor protection, helping to ensure that markets are fair, efficient and transparent, and reducing systemic risk.

1.3 The Technical Committee believes that short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities. However, there is also a general concern that especially in extreme market conditions, certain types of short selling, or the use of short selling in combination with certain abusive strategies, may contribute to disorderly markets.

1.4 The Technical Committee recommends that effective regulation of short selling comprises the following ***four principles***:

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.

b) Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities[2].

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

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

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1 Appendix I contains the list of the members of the Task Force.

2 Market authorities referred to in this report include securities regulators, self-regulatory organisations, exchanges and alternative trading facilities. In some jurisdictions, short selling regulation comprises statute-based requirements overseen by securities regulators and rules set by self-regulatory organisations, exchanges or alternative trading facilities.

1.5 The Technical Committee is of the opinion that short selling should operate in a well- structured regulatory framework in the interests of maintaining a fair, orderly and efficient market. The primary objective of such regulation would be to reduce the potential destabilising effect that short selling, used in an abusive manner, 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 (such as those used for risk management purposes).

1.6 The Technical Committee recommends these four high-level principles, as stated above, serve as the framework for market authorities to develop their short selling regime, depending on their domestic requirements. The Technical Committee is of the view that abiding by these four principles would help to bring forth a more consistent international regulatory approach to short selling. This would help to simplify the compliance process, particularly for market participants that operate in markets across different jurisdictions.

2. Objectives and Scope of this Report

2.1 As conveyed in its open letter of 12 November 2008 to the G-20[3], IOSCO considers that short selling may be problematic in the midst of a loss in market confidence. In addition, market regulators may also be concerned about the potential for short selling, particularly 'naked' short selling, to create settlement disruption. These regulatory concerns are presented in detail in Appendix II.

2.2 The mandate of the Task Force is to develop high-level principles for the effective regulation of short selling. In particular, the principles will provide guidance to market authorities with respect to short selling regulation to assist them in assessing and developing their short selling regulation framework. The Technical Committee hopes that publication of this Report will help to achieve a more consistent regulatory approach to short selling. While the Technical Committee encourages a concerted move towards a consistent approach to short selling, it recognises that the case for the regulation of short selling varies from jurisdiction to jurisdiction, depending on a range of domestic factors.

2.3 Although short selling plays an important role in capital markets, the Technical Committee noted that it is not permitted in all jurisdictions. It is not the intent of this Report to suggest or recommend that short selling should be allowed, which is a question to be left to market authorities in view of the domestic capital market development. But when short selling is introduced, an effective regulatory framework should be put in place.

[3] Available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD282.pdf

2.4 The rest of this Report discusses the regulatory approach to short selling – the four principles.

3. The Regulatory Approach towards Short Selling – The Four Principles

The Four Principles

3.1 Regulation of short selling recommended in this report focuses mainly on **four principles**:

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;
b) Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities;
c) Short selling should be subject to an effective compliance and enforcement system;
d) Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

3.2 The regulation of short selling proposed in this Report is intended to strike a balance between realising as much as possible the potential benefits of short selling (such as correcting overpriced stock, facilitating price discovery, facilitating hedging and other risk management, promoting liquidity through market making) whilst reducing the potential risks associated with short selling.

3.3 The regulation of short selling varies substantially among the Task Force members. The approach at one end of the spectrum regulates short selling throughout the activity chain – starting from the type of securities that can be short sold, the processes by which short sales are executed and right down to the settlement requirements – and at the other end of the spectrum, short selling is subject to few or no specific requirements. In light of the recent experiences during the financial crisis, the Technical Committee sees merit in having a more common approach to the regulation of short selling, in terms of according greater clarity and consistency. This will help to simplify the compliance process, particularly for market participants that operate in markets across different jurisdictions, and to limit potential regulatory arbitrage.

3.4 The Technical Committee recognises that the characteristics of the local market environment play a significant role in shaping the regulation of short selling. The recommended four high level principles will serve as the framework for market authorities to develop their short selling regime, depending on their domestic circumstances. The Technical Committee is of the view that abiding by these four principles would help to bring forth a more consistent international regulatory approach to short selling. The Task Force arrived at these four principles after

taking into consideration the practices in different jurisdictions, the domestic circumstances in jurisdictions, and views from market participants.

Definition of Short Selling

3.5 The term 'short selling' carries significantly different meanings in different jurisdictions. Market practices also vary in different markets. As a starting point toward a consistent approach to short selling, it is important that there is a common understanding of what constitute short selling activity.

3.6 It is not the intent of the Technical Committee to provide a prescriptive definition of 'short selling'. Indeed, it would be very difficult to come up with a definition which meets the requirements of different jurisdictions. The Technical Committee takes the view that it will be more pragmatic to determine whether a particular transaction is a short selling activity by looking at the nature of the transaction. In this connection, the Technical Committee sets out its view on the common characteristics of a short selling activity in Appendix III. If a transaction contains these features it should fall within the realm of 'short selling' activity.

a. The First Principle: 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

3.7 **The Technical Committee is of the view that having an effective discipline for settlement of short selling transactions is the first pillar for an effective short selling regulatory regime.** The Technical Committee recommends that regulation of short selling should *as a minimum requirement impose a strict settlement (such as compulsory buy-in) of failed trades.*

Regulatory tools used to control short selling activity

3.8 In mitigating the risks associated with short selling, market authorities have at their disposal different tools (such as price restriction rules [4] or pre-borrowing requirements amongst others) to exercise varied levels of controls at different parts of the short selling transaction chain. Some jurisdictions have adopted controls that restrict short selling while others permit short selling but have other measures designed to counter the risks of short selling, as elaborated below:

- Some jurisdictions such as Hong Kong only allow short selling of stocks which meet certain eligibility criteria;

[4] In general, under the price restriction rules, no short sale order can be executed at a price equal to or lower than the last traded price.

- In some jurisdictions, there is a requirement to pre-borrow the stocks before they can be short sold, while other jurisdictions e.g. the United States, have a 'locate' requirement;[5]
- Short selling in Canada[6], Hong Kong and Japan is subject to trading controls such as price restriction rules;[7]
- Some jurisdictions like Australia, Canada, Japan, Hong Kong and the United States require the 'flagging'[8] of short sales when orders are submitted to the exchange markets for execution;
- Margin requirements are also employed as a tool to control short selling in jurisdictions like Japan; and
- In most jurisdictions, for transactions where stocks are not delivered within the standard settlement cycle, there is some form of mandatory buy-in or close-out requirement designed to cover the failed delivery of the stocks.

3.9 Although each of the aforesaid measures plays a slightly different role, they have a common goal of reducing the associated risks of short selling. The rationale for having an eligibility criteria for stocks that can be short sold is that the prices of illiquid stocks are more vulnerable to manipulation. The pre-borrowing or 'locate' requirement and the arrangements for covering failed trades are measures to minimise any potential settlement disruption and to provide an economic linkage between the demand for short selling activity and the supply of stocks available for loan. The price restriction rules aim to prevent short sales at successively lower prices and thus might moderate the pace of market decline in extreme market conditions. The 'flagging' of short sales provides an audit trail of short sales that allow market authorities to monitor transactions, follow up on suspicious transactions and to collect information for public disclosure.

3.10 Some industry stakeholders have argued that some of these measures may have an adverse impact on costs of short sale transactions, and possibly affect the execution of trades generally thereby raising trading costs for all investors. This would offset some of the benefits of short selling.

3.11 The Technical Committee recognises that not all these measures may be appropriate for universal application. These measures may have different levels of effectiveness

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5 In the United States, a broker-dealer, prior to effecting a short sale order, must borrow the stock, enter into a bona fide arrangement to borrow the stock, or have reasonable grounds to believe that the stock can be borrowed so that it can be delivered on the date delivery is due. This is known as the 'locate' requirement.

6 Price restriction rules currently apply only to stocks that are not interlisted in Canada and US exchanges.

7 In the United States, the price restriction rules were removed in July 2007. In April 2009, the U.S. determined to re-examine this issue by proposing and seeking public comment on price restriction rules.

8 'Flagging' used in this report refers to the system that requires putting a marker on each short sale that a broker sends to the exchange or alternative trading facility for execution.

depending on specific local market conditions and the nature of the market infrastructure already in place. Also, introducing some of these measures (such as price restriction rules or 'flagging' short sales) in some jurisdictions may be operationally difficult and may involve prohibitive costs for the regulators and market participants.

Settlement discipline

3.12 The Technical Committee believes that having in place regulation for strict settlement of failed trades would discourage and deter abusive short selling behaviour – i.e. those who short sold but with no intention of, or reasonable plan, for effecting delivery. While this measure is often adopted to deal with failed trades irrespective of whether the trades are short sales or long sales, it can be an effective tool to minimise the potential disruption that may arise from short selling.

3.13 In some jurisdictions, the settlement of outstanding transactions which have failed to settle within the standard settlement cycle[9] is achieved by compulsory buy-in or close-out. Market practices for the compulsory buy-in or close-out vary in different markets. In some markets, the process may be initiated by the central counterparty or securities settlement system. In others, the compulsory buy-in or close-out is requested by the buyer who has not received the stocks after a certain number of days following the end of the standard settlement cycle. To further discourage settlement failure, in some markets, a monetary penalty is also imposed on market participants that have failed to settle their trades within the standard settlement cycle.

3.14 Having a short settlement cycle, that is, the time lapse between trade execution to settlement of trade, can help to reinforce settlement discipline. A long settlement cycle may increase the risks of failed trades that remain undetected and may undermine the regulatory purpose of strict settlement of failed trades. Conversely, a short settlement cycle will reduce the incentive to short sell with no intention of, or reasonable plan, for effecting delivery. The recommendations developed by CPSS and IOSCO in November 2001 suggest that trades should be settled no later than T+3 as part of the standard settlement cycle and the benefits and costs of a standard settlement cycle shorter than T+3 be evaluated.[10] The Technical Committee strongly encourages national market authorities to consider implementation of these recommendations if they currently do not have a regulatory structure consistent with the recommendations.

3.15 Factors such as the time period of a settlement cycle, how many days after settlement date would the buy-in or close-out be triggered, who is to initiate the

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[9] The term 'standard settlement cycle' used in this report refers to the time period between the trade date and the date that the stocks are due for delivery.

[10] Details of the recommendations are explained in 'Recommendation 5: Settlement cycles', CPSS-IOSCO Recommendations for Securities Settlement Systems in November 2001.

buy-in or close-out, or whether a penalty should be imposed should be considered by national market authorities having regard to domestic conditions. The point to bear in mind is that the stricter the settlement requirements, the more likely it is that settlement requirements can act as an effective regulatory tool to counter potential abusive short selling behaviour. Having said that, market authorities should be mindful that the settlement discipline requirements may have operational implications for the securities lending market [11].

3.16 Beyond this strict settlement pillar of regulation, regulators could reinforce their short selling regulatory regime by adopting other regulations such as eligibility criteria for stocks that can be short sold, pre-borrowing or 'locate' requirements, price restriction rules, or 'flagging' of short sales, as appropriate for individual markets.

b. The Second Principle: Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities[12]

3.17 **The Technical Committee believes that enhanced and meaningful reporting of short selling is the second pillar of an effective short selling regulatory regime.** The Technical Committee is of the view that to achieve the enhanced level of transparency of short selling as contemplated by the second principle, jurisdictions should consider some form of reporting of short selling information to the market. The Technical Committee recommends that for those markets where reporting to the market is considered inappropriate, then as a minimum requirement, reporting should be made to market authorities.

Summary of the Conclusions of the 2003 Report on Transparency of Short Selling

The position in 2003

3.18 The Technical Committee had previously examined the role that greater transparency of short selling might play in securities markets and the forms such transparency might take in the 2003 Report.

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11 For example, to avoid exposing their clients to compulsory buy-in or close-out for failing to settle within the standard settlement cycle, the lending agents will want to make sure that they are able to return the loaned securities to their clients upon their recall. They may want the comfort of a larger buffer of the securities in hand to accommodate the late return of loaned securities. This may reduce the supply of lendable securities available to the market and may affect trading activities and market liquidity.

12 In some jurisdictions, regimes are already in place to provide short sale information to the markets. For example, in the United States, market authorities publish aggregate short interest position data on a bi-monthly basis. See Appendix IV for additional details regarding individual jurisdictions' reporting regimes.

3.18.1 The Technical Committee noted that short sales contain information that may be of value to both regulators and market users. The IOSCO Objectives and Principles of Securities Regulation already identify disclosure of short sales, or at least their disclosure to regulators, as a possible regulatory tool[13].

3.18.2 While the Technical Committee took the view that, in general, regulators should aim to promote appropriate transparency to support market efficiency, it recognised that achieving this in practice is often difficult, requiring reconciliation of a number of considerations. Firstly, the information message from a short sale may be ambiguous, and possibly open to various interpretations - though that in itself is not necessarily a good reason why data should not be more widely available, especially if any explanation as to its limitations is also available. Secondly, there may be some risks that excessive transparency could alter the risk-reward ratio for short sellers to a degree that the price-correcting benefit of short selling (and the accompanying liquidity) is reduced.

3.18.3 In respect of disclosure of short sales information to regulators, ready regulatory access to information on short selling may provide improved real-time insight into market dynamics and early warnings of potentially disruptive or abusive use of short sales, or (in the case of non-current data) at least expedite post-event investigations.

3.18.4 In this respect, the Technical Committee encouraged regulators to consider the appropriate level of transparency in this area. The Technical Committee recognised the difficulties in assessing the correct balance between the benefits and potential drawbacks of any transparency regime and the need to structure it in a way that takes into account relevant factors in the local environment.

The current position

3.19 The recent events and measures taken by some jurisdictions in disclosing short positions[14] indicate that enhanced transparency of short selling has the potential to assume a greater role in effective securities regulation. While it is the view of the Technical Committee that, in general, regulators should aim to promote appropriate transparency of short selling information to the market, it recognises that there are a number of considerations, as highlighted in the 2003 Report. Firstly, information on short selling may mislead the market and secondly, increasing transparency might expose short sellers and subject them to potential short squeeze. In this

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13 *IOSCO Objectives and Principles of Securities Regulation*, IOSCO Report, September 1998 (updated in February 2008), stated that: '*Disclosure of short sales and securities lending (or at least their reporting to the regulator) is a tool for the further reduction of risk*.'. It is available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD265.pdf.

14 The Technical Committee notes that the definition of 'short position' varies by jurisdiction, depending on the local short selling regulatory regime.

respect, the Technical Committee encourages market authorities in structuring a reporting regime to the market to consider the appropriate level of transparency having regard to these important considerations.

Objectives of reporting of short selling

3.20 The Technical Committee recommended in the 2003 Report that where regulators are contemplating the introduction of a transparency regime for short selling, that they should carefully address, among others, the objective of the transparency regime for short sales and the most effective way of achieving it. In other words, regulators must be clear about what they want or expect to achieve in establishing a reporting regime of short selling. In this regard, the Technical Committee proposes that regulators in establishing a reporting regime take into account the following as part of the objectives of their regime:

3.20.1 Provide ready access to information on short selling to improve insight into market dynamics;
3.20.2 Deter market abuse;
3.20.3 Mitigate the potential disorderly market effects of aggressive short selling;
3.20.4 Provide early warning signs of a build up of large short positions and alerts to prompt investigation into suspicious activities that may be potentially abusive or disruptive to the orderly functioning or stability of the markets; and
3.20.5 Provide evidentiary proof that aids in post-event investigation and disciplinary action.

3.21 Currently, different markets have different reporting requirements (some of the reporting requirements are on a temporary basis), as presented in the table set out in Appendix IV. Broadly speaking, there are two models that are commonly in use for short selling reporting – (1) flagging of short sales[15] and (2) short positions reporting.

3.22 The Technical Committee recognises that some markets require the flagging of short sales while some jurisdictions impose reporting of short positions. Both models have their own merits and each could serve the above identified regulatory objectives. If national market authorities would like to have a comprehensive reporting regime, they may choose to adopt both models.

Short Positions Reporting

3.23 In designing their short positions reporting regime, market authorities will need to determine matters such as what is required to be reported, the frequency of such reporting, the trigger level, if any, of reporting, the constituents responsible for

[15] See *supra* footnote 7.

reporting and the recipients of such reports. These issues will have to be considered in the context of each authority's regulatory objectives for the reporting of short selling. The Technical Committee discusses below each of these items to aid market authorities when considering the scope of a reporting regime.

Equity shares/derivatives

3.23.1 The Technical Committee understands that the reporting of short positions might not provide a full picture if the data excludes derivatives. This may also induce a migration of trading activities to the derivative market. As stated in the 2003 Report, compiling data on the total short position covering both equity shares and derivatives could be highly complicated and there may be challenges in interpreting the information due to the likelihood of double counting.

3.23.2 In recent years, there has been an explosion of financial innovation. Apart from equity shares, a wide range of financial derivative products is available for market participants to establish short exposures. The Technical Committee recognises that including derivative positions in the reporting requirement would introduce more complexity into the system. There may also be practical issues involved in the collection of derivative data. OTC derivatives can present particular challenges in both respects. The Technical Committee suggests that market authorities make their assessment of the balance of difficulties and benefits of reporting short positions on derivatives and consider including derivatives in their reporting regimes to the extent that they consider it useful for their domestic regulatory objective and purpose and to the extent that it is practicable to do so.

Net or gross positions reporting

3.23.3 The requirement of short positions reporting raises the question of whether the reporting ought to be done on gross or net basis. The Technical Committee is aware that in some markets, reporting of gross short positions is required while in others, the approach taken is to impose reporting of net open short positions. National market authorities should consider, against the background of their objectives and usage of the data collected, whether reporting of short positions on gross or net basis, is more appropriate.

The trigger level of reporting, and frequency of reporting

3.23.4 Some markets have in recent months introduced short positions reporting requirements as part of the temporary measures to address concerns regarding short sales in their markets. These temporary measures, in general, require the notification of net open short position exceeding a de-minimis

level. In some markets that introduced reporting requirements as part of temporary measures, the reporting obligation is triggered once net open short positions exceed 0.25% of the issued share capital of the relevant stocks. In most cases, reporting is also required if there are subsequent changes to the size of short positions previously reported or the size of the positions has reached an additional threshold. Although the reporting requirements in these markets are similar, the respective market authorities have had very different experiences and mixed views regarding the information relevance, completeness and hence, the value of the information.

3.23.5 In considering the appropriate trigger level of reporting and frequency of reporting, the Technical Committee is mindful that setting a threshold too low or requiring too frequent reporting may be overly burdensome for constituents responsible for reporting. On the other hand, setting too high an initial threshold or not requiring the reporting of significant changes in positions would fail to capture information on short positions that could impact the market. Consideration must also be given to the balance between ease and costs of compliance for market users and providing timely and useful information to reduce the risk of manipulative and other unfair trading practices.

3.23.6 The Technical Committee recognises that reporting of short positions is a 'greenfield' area where market authorities in many markets have limited experience. It expects there will be changes to the recently introduced short positions reporting requirements when market authorities gain more experience. Against this background, if a jurisdiction determines to implement a short position reporting regime, or modify a regime already in existence, the Technical Committee encourages national market authorities to consider whether to introduce an initial reporting threshold and trigger levels for reporting of significant changes in positions. Any such reporting threshold or trigger levels would need to be appropriate to their jurisdictions' markets and may need to be fine-tuned as more experience is gained.

Timing of reporting

3.23.7 To be effective, reporting of short positions should be timely. The Technical Committee is of the view that the reporting be done as soon as practicable and encourages the market authorities to be mindful of the time lag between the creation of positions and their reporting, it should be as short as possible. The Technical Committee recognizes, however, that the frequency and timing of reporting to markets and/or market authorities should be determined by each jurisdiction based on its objectives for having short position reporting.

The constituents responsible for reporting

3.23.8 The Technical Committee contemplates that it would be beneficial for the reporting to be done by holders of the short positions. The concern raised with this approach is the risk of failure to report by off-shore investors, which is a long-standing issue relating to difficulties in cross-border enforcement. The Technical Committee addresses the challenges in cross-border enforcement in the discussion of the third principle below.

3.23.9 It has been proposed that the responsibility for reporting be placed on brokers as they are subject to domestic regulation and are held accountable for their conduct by the national market authorities. However, the shortcoming of this approach is that brokers may not have complete information about their clients' positions, and information provided by them is only as good and as accurate as information given to them by their clients. Although the Technical Committee believes that it is more beneficial to impose the reporting requirements on the ultimate holders[16] of the short positions, it also recognises that this may not be feasible in some jurisdictions due to the fact that market authorities lack the regulatory power to require all ultimate holders to report.

Flagging of Short Sales

3.24 Reporting of short sales by 'flagging' short sale orders is another approach to enhance transparency of short selling. As mentioned earlier, 'flagging' of short sales is a system that requires putting a marker on each individual short sale order that a broker sends to the exchange or alternative trading facility for execution. This marker makes a short sale transaction easily traceable.

3.25 The flagging of short sales provides market authorities with real time information of short selling, which may particularly be useful in a fast moving market. It also creates an audit trail of short sales that allow market authorities to follow up on suspicious activity. The data collected from 'flagging' can also be used, to some extent, in monitoring compliance of the short position reporting. It provides a basis for a consistency check with the reporting of the short positions in the cash market. As brokers, who are subject to domestic regulation, are responsible for flagging of short sales, they are held accountable for any failure to report short sales by the national market authorities. For this reason, it may be relatively easier for national market authorities to monitor compliance with the flagging of short sales as compared to short positions reporting.

[16] If a person is allowed to exercise discretion to trade independently without the day-to-day direction of the ultimate owners, the person should be obligated to report the short positions. The most common example is a fund manager who manages assets of the fund according to the investment policy of the fund.

3.26 However, flagging of short sales does not help market authorities to assess the outstanding short positions in the market or identify any large short positions held by market participants unless market participants are also required to flag their buy orders which are used to close the short positions. However, even if 'close-out' buy orders are flagged, this issue cannot be completely resolved. This is because short sellers do not need to go to the market to close the short positions in some cases. For example, they may acquire the equity shares from other instruments (such as options) to close the short positions.

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

3.27 A stringent regulatory system is not enough to deter abusive market behaviour. Enforcement action is therefore necessary for ensuring compliance. **The Technical Committee views that an effective compliance and enforcement system is the third pillar of an effective short selling regulation regime**. This is enshrined in the IOSCO Objectives and Principles of Securities Regulation which states the following principles for the enforcement of securities regulation:

- The regulator should have comprehensive, inspection, investigation and surveillance powers.
- The regulator should have comprehensive enforcement powers.
- The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

Enforcement and compliance

3.28 The Technical Committee holds the view that instituting a strict settlement of failed trades is one of the pillars of a short selling regulatory regime. This is critical in order to instil settlement discipline and minimise the potential for settlement disruption risk. In this regard, market authorities should consider measures that provide a strong deterrent effect. Market authorities in some markets have adopted the approach of imposing a financial penalty that is meaningful enough to discourage breaches of settlement rules. To evaluate whether the settlement discipline is working as intended, regular monitoring and inspections by market authorities of settlement failures is important, especially for those firms which frequently fail to deliver.

3.29 In most jurisdictions, regulators have the power to inquire into and require information from persons and entities that are domestically licensed or registered in cases where there is suspicion of any violation of regulation. But for effective policing of disclosure of short positions or short sales by short sellers (who may not be licensed persons), the Technical Committee encourages market authorities to consider whether they are able to extend the power to require information from

parties suspected of breach, beyond the scope of licensed or registered persons if they lack such power.

3.30 The Technical Committee considers that jurisdictions which operate a short sale flagging regime should require appropriate parties (in particular those holding accounts of short sellers or executing short sale transactions either for agency or proprietary purposes) to maintain books and records of short sales for a sufficient period of time. These books and records can help market authorities in their post-event investigation work; market authorities may be able to reconstruct and understand the events that had taken place, which is important as part of the investigation work. Brokers and institutional investors, who are usually significant players in the short selling market, in general, would have kept books and records of their trades in any case for their own business purpose.

Monitoring and surveillance

3.31 Monitoring and surveillance can be carried out through the reporting of short positions and/or flagging of short sales. The information gathered from the reporting of short positions and/or flagging of short sales can be used to help detect any potential abusive trading practices as well as to alert market authorities of the build up of large open short positions which may pose systemic risk to the market. If jurisdictions have a short sale flagging and/or short position reporting regime, the Technical Committee encourages market authorities to establish a mechanism to analyse the information obtained to identify potential market abuses and systemic risk.

Cross-border enforcement cooperation

3.32 IOSCO has already put in place a framework for international enforcement cooperation. The basic tools needed by securities regulators for effective cross-border enforcement cooperation are set out in the IOSCO Objectives and Principles of Securities Regulation[17]. One such tool is the authority to collect information (including statements and documents in connection with the investigation of potential securities law violations) on behalf of foreign counterparts.

3.33 IOSCO has also created the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU) of 2002 that establishes the cooperation among securities regulators to assist each other's investigation by sharing information[18].

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17 See *supra* footnote 12.

18 Please refer to the Principles of Cooperation in Regulation.

3.34 As stated in the open letter of 12 November 2008 to the G-20 forum[19], the IOSCO members have agreed to augment their international enforcement cooperation efforts in response to cross-border challenges that have emerged since the credit crisis began, and which are expected to continue to arise as the crisis unfolds. These challenges include increasing types of cross-border market manipulation and other fraud, inappropriate uses of exotic financial products and extreme market conditions that exacerbate the impact of regulatory non-compliance by market participants. These challenges make it incumbent on financial regulators to strengthen their cooperation with foreign counterparts. The Technical Committee suggests that market authorities review whether their existing cross-border information sharing arrangements are sufficient to facilitate cross-border investigation.

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

3.35 As mentioned in the 2003 Report, where there is regulation of short selling, it should be developed with a view to capturing the potential benefits of short selling. **The Technical Committee considers that flexibility in short selling regulation to cater for market transactions that are desirable for efficient market functioning and development is the fourth pillar of an effective short selling regulatory regime.**

3.36 The Report has discussed in the preceding sections the benefits of short selling, and its role in the market place to facilitate market development.

3.37 The short selling regulation regime that the Technical Committee envisages is one that should not stifle legitimate short selling activities. The regime should not restrict short selling activities that are critical to the efficient functioning of capital markets, and the orderly development of the market for better risk management.

3.38 Activities falling under this category may include bona fide hedging, market making and arbitrage activities. As these activities generally provide benefits to the market and are unlikely to pose risks that will destabilise the market, the Technical Committee considers that short sale regulation should consider building in flexibility for these activities where appropriate. For example, national market authorities may consider that failed trades arising from market making activities are not subject to strict settlement requirements but rather allow more time to close out the positions due to such failed trades. In jurisdictions where short selling is subject to restrictions (such as price restriction rules or pre-borrowing requirement), national market authorities may consider creating exceptions to the restrictions for these activities. For example, if naked short selling is prohibited in the market, market makers engaging in certain market activities may be exempted so that they

[19] See *supra* footnote 2.

can short sell the relevant shares immediately to accommodate temporary investor buying demand and also to hedge the risk arising from their market making activities. This flexibility allows these market activities to be carried out with more efficiency and at lower cost.

3.39 The question of whether these so called 'exempted' activities should also be exempted from reporting of short position requirements has been raised. The Technical Committee believes that if the reporting is only to market authorities, the reporting regime may need to cover the 'exempted' activities in order for market authorities to capture a full and complete picture of the level of short selling in the market. Where public disclosure of individual positions is required, however, market authorities may need to consider whether certain types of activities should be exempted to protect the interests of the parties engaged in the 'exempted' activities. This may be particularly relevant to market making activity.

3.40 In order to avoid any potential abuses in relation to any exemptions, it is important that market authorities clearly define the exempted activities. For example, the terms 'market making' and 'hedging' may have different meanings attached in different markets. Market authorities should carefully consider whether the definition of the exempted activities would include any other activities which are not intended for exemption.

Appendix I

Members of the Task Force on Short Selling

Chair

Securities and Futures Commission, Hong Kong

Members

Australian Securities and Investments Commission

Comissão de Valores Mobiliários, Brazil

Autorité des marchés financiers, France

Bundesanstalt für Finanzdienstleistungsaufsicht, Germany

Commissione Nazionale per le Società e la Borsa, Italy

Financial Services Agency, Japan

Securities Commission, Malaysia (representing EMC Working Group 2)

Ontario Securities Commission

Autorité des marchés financiers, Quebec

Comisión Nacional del Mercado de Valores, Spain

Swiss Financial Market Supervisory Authority

Financial Services Authority, United Kingdom

Securities & Exchange Commission, United States

Appendix II

Regulatory Concerns Relating to Short Selling

1. As noted by the Technical Committee in the 2003 Report, the concerns surrounding short selling pertain to its capacity to add an incremental weight of selling to the weight of 'long' sales.[20] This raises questions as to the potential for this incremental flow of stock to bring about disorderly markets; and facilitate market abuse. In addition, market authorities may also be concerned about the potential for short selling, particularly 'naked' short selling, to create settlement disruption. These regulatory concerns are presented below.

Disorderly markets

2. Short selling is perceived to have the major benefit of facilitating a more rapid repricing of over-valued securities than would otherwise be the case. Also, short sellers are often contrarian investors that mitigate steep, temporary price increases. However, the downside to short selling is its potential to create disorder owing to the extent and speed of these 'corrections'. For instance, short sales may occur so rapidly that a price goes into significant decline before other market users have an opportunity to step in with fresh buying orders. Alternatively, the speed and/or weight of selling may cause potential buyers to stand back from the market because they are uncertain exactly what is occurring. In some cases, a precipitous decline caused by short selling may even encourage 'long' holders of stock into selling.

3. Concerns may therefore be twofold. First, that the process of decline may itself be disorderly. Second, that the outcome of any decline may be an 'overshoot' on the downside great enough to trigger undesirable secondary consequences[21]. These could include, for example, problems for an issuer (resulting, perhaps, from customers or lenders inferring concerns about its commercial prospects from the share price decline), further forced selling by institutions needing to meet regulatory solvency ratios, or even pressure on other areas of public policy.[22]

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20 For purposes of the 2003 Report, sales of securities which the seller owns and has not needed to borrow.

21 Overshooting can also result from other types of trading as well, not just short sales.

22 A notable example of concern over the wider financial impact of sustained short selling was the Hong Kong authorities' concern during the 1997 Asian crisis. In this case, hedge funds took advantage of the Hong Kong currency board mechanism. They on one hand attacked the Hong Kong currency and on the other hand built up large short selling open positions. The attack on the Hong Kong dollar caused interest rates to rise, which in turn pushed down stock prices. The rapid decline in stock prices and the weakened Hong Kong currency caused panic selling from institutional and retail investors which exacerbated the selling pressure on the market.

4. None of these is to say that short sales necessarily cause disorderly conditions, or that disorderly conditions cannot arise from long sales. The regulatory concern is that short sales may make the risk of disorderly markets higher than it might otherwise be. The regulatory judgement is whether, in the circumstances, this warrants regulatory action.

Market abuse

5. A second regulatory concern lies in the way in which short selling may be used to assist market abuse. That does not make short selling abusive in itself. But its ability to add incremental weight to a downtrend, or to be used in conjunction with insider dealing by those with adverse information about an issuer, could make it a potentially useful tool for those who are intent on abusing a market.

6. Precisely what regulators consider constitutes manipulative activity varies between jurisdictions. But selling, accompanied by false rumours designed to encourage others to sell, is a clear case of abusive behaviour. Selling in an attempt to move a price to a different level with a view, say, to triggering a much larger profit (or reduce a loss) on a related transaction, e.g. a related derivative, enters a greyer area. But behaviours designed to position prices, distort markets or mislead investors normally constitute, or at least sit on the edge of, market abuse. The abuse is the same irrespective of whether the selling is long or short, but short selling may well increase the scope to carry out the abuse.

Settlement disruption

7. Short selling may also raise regulatory concerns in the area of settlement. The principal issue here is whether the short selling process is conducted in a way that causes difficulties for the buyer. Timely delivery may be particularly important for a buyer in the context of, for instance, being able to exercise voting rights or to meet obligations in respect of an onward chain of transactions. Indeed, where there is generally inadequate provision to ensure the timely settlement of short sales, there may be wider systemic risk.

8. The potential difficulties in this area are likely to arise from two sources. The first is where the short seller has not arranged borrowing ahead of his sale and feels under no strong incentive to deliver (and the rules/disciplines of the system provide latitude not to). The second is changing supply and demand in the securities lending markets. Although securities lending markets have grown in liquidity and sophistication in recent years, a short seller remains vulnerable to sudden shortages or the unexpected recall of stock.

Appendix III

What is 'short selling'?

1. In some jurisdictions, 'short selling' is defined in the law or the rules. For example, short selling is only allowed in some jurisdictions if it is a 'covered' short - that is - the seller has borrowed or made provision to borrow the securities before the sale is executed. On the other hand, rather than defining 'short selling', some jurisdictions spell out what constitutes 'prohibited' activity in relation to short selling[23]. For example, in some markets, prohibited short selling refers to 'naked' short selling, i.e. a short sale transaction where no prior arrangement is made to cover the short sale.

2. The Technical Committee observes that short selling, howsoever defined, has some common features and takes the view that it will be more pragmatic to determine whether a particular transaction is a short selling activity based on the presence of two factors: (i) a sale of stock that (ii) the seller does not own at the point of sale[24]. If a transaction contains these features it should fall within the realm of 'short selling' activity that is to be regulated.

3. Regarding the circumstances under which a person would be considered to own or not to own a stock, the Technical Committee envisages that circumstances where the seller owns the stock include, but not limited to, the following:

   (i) the seller has purchased or entered into an unconditional contract to purchase the stock but has not yet received delivery;
   (ii) the seller has a title to other securities which are convertible into or exchangeable for the stock to which the order relates (and has tendered the application to convert or exchange);
   (iii) the seller has an option (and has exercised such an option) to acquire the stock to which the order relates;
   (iv) the seller has rights or warrants (and has exercised such rights or warrants) to subscribe to and to receive the stock to which the order relates;
   (v) the seller is making a sale of a stock that trades on a 'when issued' basis and has entered into a binding contract to purchase such security, subject only to the condition of issuance of the security; and
   (vi) the seller has bought the stock in one market and then sells the same stock in another market (regardless of whether it is an overseas market).

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[23] By way of examples, the Corporations Act 2001 of Australia and the Securities and Futures Ordinance of Hong Kong.

[24] In some jurisdictions, certain sales of owned securities might be subject to rules governing short sales, e.g. if the seller cannot reasonably expect to deliver the stock by the settlement date.

Appendix IV

Summary Table of Short Selling Reporting Requirements

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Jurisdiction	**Short Selling Transaction Disclosure**[25]	**Short Selling Position Disclosure**[26]	**Reporting Party**	**Disclosure to the market**	**Frequency**[27]	**Collector/ Publisher**
Australia (ASIC/ASX)	Yes Investor via broker	No	Broker	Aggregate short sell by security disclosed to public daily.	Real time	ASX
Canada	Yes Via the broker[28] Not publicly disseminated	Yes See footnotes 24 and 26 below	Broker See footnote 26 below	Aggregate short interest reporting by security carried out by broker twice monthly. Data is publicly released twice a month by the TSX. See footnote 26 below.	See footnotes 24 and 26 below	See footnotes 24 and 26 below

25 Not limited to flagging of disclosure at point of execution.

26 Relating to initial disclosure only.

27 Further disclosure triggers

28 Under the Canada's Universal Market Integrity Rules (UMIR), a marketplace participant (brokers and certain subscribers to Alternative Trading Systems) is not permitted to enter an order to sell a security on a marketplace that on execution would be a short sale unless the order is marked as a 'short sale'. The short sale marking requirement does not apply to orders automatically generated by the trading system of an exchange or QTRS in accordance with marketplace rules in respect of the applicable market maker obligations.

Also, the UMIR currently requires marketplace participants to prepare and file a short position report twice-monthly with respect to securities traded on a marketplace. A marketplace participant must provide the aggregate short position of each individual account in respect of each listed or quoted security. Based on these reports, the Toronto Stock Exchange (TSX) produces the Consolidated Short Position Report (CSPR) on behalf of the various stock exchanges in Canada. The TSX continues to produce the CSPR as a service for the market regulator in Canada (IIROC). It also sells it as a data product and provides it to listed issuers at no cost.

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France (AMF)	No	Yes Investor disclosure triggered if net position (cash + derivatives) ≥ 0.25% in respect of financial sector stocks	Investor	Short position reporting made by investor to regulator and data is made publicly available by investor.	Any change	Any of the officially appointed information providers
Hong Kong (SFC)	Yes Investor via broker	Yes (for positions ≥ 1% of the issued share capital, where holder has a long position ≥ 5% of the issued share capital)	Investor	Aggregate short sell by security disclosed to public daily. Short selling positions disclosed to public, under Part XV of the Securities and Futures Ordinance on T+3.	Positions fall below 1%; increase / decrease in positions resulting in crossing over a whole percentage number	The Stock Exchange of Hong Kong
Japan (FSA)	Yes Investor via broker	Yes Investor disclosure triggered ≥ 0.25% of outstanding stocks[29]	Investor via broker[30]	Short position reporting made by investor to exchanges via broker at ≥ 0.25% and publicly disclosed by exchanges daily (effected from 07/11/08 until 31/07/09).[31]	Each day on which the reported short position changes.	Exchanges

29 The short position must also exceed 50 trading units.

30 In the case of a fund, the fund manager is required to report, but not the ultimate investors or beneficiaries of the fund.

31 From December 16, 2008, if the position holder is an individual, the name and address of the individual are not publicly disclosed (but reported to exchanges) unless the individual holds a short position of 5% or more of outstanding stocks.

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				In addition, aggregate price of short selling regarding all securities, and aggregate price of short selling by sector (33 sectors in total) publicly disclosed daily by exchanges		
Spain (CNMV)	No	Yes Investor disclosure triggered ≥ 0.25%	Investor	Short selling position reporting made by each individual investor and data is publicly available.	Any change resulting from new trades or hedges (changes in the position due to changes in delta do not trigger new disclosure)	CNMV
Switzerland (FINMA)	No	Yes (short derivative positions only) For positions ≥ 3% of shareholdings the investor has to report all acquisition holdings and all derivative short holdings (in two separate 'pots')	Investor	Position reporting made by investor to issuer and exchange. Data is made publicly available by issuer and exchange. Report within 5 working days. Disclosure within 7 working days		Issuer / Exchange
United Kingdom (FSA)	No	Yes Investor disclosure triggered of	Investor	Short position reporting made by investor to the market at ≥	For UK financial sector stocks once initial trigger threshold	Position holders are obliged to disclose to

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		net short positions ≥ 0.25% in respect of UK financial sector stocks or stocks of companies which are undertaking rights issues. All economic interests giving a short position need to be taken into account in calculating the size of the position.		0.25%. (Expiry scheduled 30 June 2009 for UK financial sector stocks)	is crossed and then as further trigger increments are crossed (whether the position is increasing or decreasing). For rights issue stocks once the initial trigger threshold is crossed.	the market via a regulatory information service.
United States of America (SEC)	Yes With certain exceptions, disclosure of gross short sales required under Rule 10a-3T for institutional investment managers as described under Section 13(f) of the Securities Exchange Act of 1934. Rule 10a3-T is a temporary rule that will expire on August 1, 2009 unless the Commission takes additional	Yes With certain exceptions, disclosure of gross short positions is required under Rule 10a-3T. Institutional investment managers must disclose gross short positions in Section 13(f) securities on Form SH if the start of day short position, the gross number of securities sold short during the day, or the end of day short position, when viewed independently, exceeds 0.25%	Institutional investment managers as described under Section 13(f) of the Securities Exchange Act of 1934 that exercise investment discretion with respect to accounts holding certain classes of equity securities having an aggregate fair market value of at least US$100 million.	Data submitted to the SEC on Form SH is non-public.	Institutional investment managers are obligated to file Form SH once per week on a one week delayed basis to the extent the reporting party has reportable short sales or short positions.	Form SH is submitted to the SEC via the EDGAR system and is not published.

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	action before that time.	of the total shares outstanding of that class of the issuer's securities, or has a fair market value exceeding US $10 million.				
United States of America (SROs)	No	Yes Pursuant to self-regulatory organization (SRO) rules, broker-dealers must report short interest positions in all equity securities to the applicable SRO.	Broker-Dealers	Broker-dealers must report short interest positions for all equity securities with each symbol individually designated. Each SRO makes publicly available the aggregate short interest position in each equity security.	Broker-dealers must report short interest positions on a bi-monthly basis.	SROs collect and publicly disseminate short interest position data via their Internet websites and other publicly accessible media outlets.