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IOSCO publishes principles for the effective regulation of short selling

The International Organization of Securities Commissions' (IOSCO) Technical Committee has published a final report entitled *Regulation of Short Selling* which contains high level principles for the effective regulation of short selling. The principles were developed by the Task Force on Short Selling (Task Force) following consultation with regulators and market participants from around the world who were generally supportive of the proposals.

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.
- 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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Kathleen Casey, Chairman of the Technical Committee, said:

“IOSCO believes that the adoption of these four principles by securities regulators will contribute to the development of a more consistent global approach to the regulation of short selling. The principles strike a balance between maintaining the benefits that short selling contributes to the functioning of markets while ensuring that regulators have the necessary tools to counteract the abusive use of short selling.

“While IOSCO encourages a move towards a more concerted regulatory approach to short selling, it recognises that its regulation will vary from jurisdiction to jurisdiction depending on local circumstances. However, while different regulatory philosophies and approaches will continue to be applied, these principles provide a firm grounding for securities regulators development of their oversight regimes.

“The development of these principles by IOSCO demonstrates our commitment to helping combat the effects of the current financial crisis and ensuring markets remain fair, efficient and transparent, investors receive adequate protection and systemic risk is reduced.”

The Task Force was established by the Technical Committee in November 2008 in response to concerns regarding the impact short selling was having in the extreme market conditions created by the financial crisis. The Task Force's aims were to work to eliminate gaps between the different regulatory approaches to naked short selling whilst minimising any adverse impact on legitimate activities, such as securities lending and hedging, which are critical to capital formation and reducing market volatility.

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RECOMMENDATIONS

The report outlines the minimum that regulators should do in order to support each of the four principles.

The First Principle: *appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets.*

In order to reduce or minimise the potential risks from short selling, regulators should have an effective discipline for the settlement of short selling transactions. As a minimum requirement this should impose strict settlement (such as compulsory buy-in) of failed trades.

The Second Principle: *a reporting regime that provides timely information to the market or to market authorities*

In order to achieve this enhanced level of transparency regarding short selling activity, jurisdictions should consider some form of reporting of short selling information to the market or to market authorities.

The Third Principle: *an effective compliance and enforcement system.*

This is essential for an effective short selling regulatory regime. The regulators should:

- monitor and inspect settlement failures regularly;
- require appropriate parties to maintain books and records of short sales for a sufficient period of time to assist with post-event investigation work;
- 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;
- establish a mechanism to analyse the information obtained from the reporting of short positions and/or flagging of short sales to identify potential market abuses and systemic risk; and

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- review whether their existing cross-border information sharing arrangements are sufficient to facilitate cross-border investigation.

The Fourth Principle: *allow appropriate exceptions for certain types of transactions for efficient market functioning and development*

It is necessary that there is flexibility in short selling regulation in order to allow market transactions that are desirable for efficient market functioning and development. Therefore regulatory authorities should at a minimum clearly define the exempted activities and the manner in which these exemptions should be reported.

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NOTES FOR EDITORS

1. The Regulation of Short Selling - Final Report is available on the IOSCO website.
2. The Task Force was chaired by Martin Wheatley, Chief Executive Officer of the Securities and Futures Commission of Hong Kong.
3. The Technical Committee, a specialised working group established by IOSCO's Executive Committee, is made up of eighteen agencies that regulate some of the worlds larger, more developed and internationalized markets. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. Ms. Kathleen Casey, Commissioner of the US Securities and Exchange Commission is the Chairman of the Technical Committee. The members of the Technical Committee are Australia, Brazil, China, France, Germany, Hong Kong, India, Italy, Japan, Mexico, the Netherlands, Ontario, Quebec, Spain, Switzerland, United Kingdom and the United States.
4. IOSCO is recognized as the leading international policy forum for securities regulators. The organization's membership regulates more than 95% of the world's securities markets and IOSCO is the international cooperative forum for securities regulatory agencies. IOSCO members regulate more than one hundred jurisdictions and its membership is steadily growing.
5. IOSCO aims through its permanent structures:
 - to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
 - to exchange information on their respective experiences in order to promote the development of domestic markets;
 - to unite their efforts to establish standards and an effective surveillance of international securities transactions;
 - to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

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