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CESR Proposal for a Pan-European Short Selling Disclosure Regime

London Stock Exchange and Borsa Italiana welcome the opportunity to provide input to CESR's proposal to introduce pan-European standards for the regulation of short selling. We support CESR's aim of introducing a harmonised approach across Europe. This will ease the administrative burden of market participants having to comply with different sets of national short selling regulations.

We would like to make a few introductory remarks with respect to CESR's proposal before addressing the technical questions raised in the Consultation Paper ("CP") (set out in Appendix 1 below).

Role and benefits of short selling

First of all, we are pleased that CESR recognises the role and benefits of short-selling in financial markets.

It is widely recognised that short selling contributes to a more efficient price discovery process and provides market participants with an effective hedging and risk management tool:

- Short selling allows negative information about a stock to be more fully reflected in the stock price: it will help to correct overpricing and provide more accurate valuation of companies. This is particularly important in bull market periods when short selling can dampen irrational overshoots.
- Short selling is widely used for hedging and risk management purposes. It may be vital in the context of capital raising of equity or equity-linked products (e.g. convertible bonds) as underwriters and investors may want to hedge part of their exposure in the company's stock in order to take part in the offering.

Research commissioned by the London Stock Exchange on the effects of the restrictions on short selling of financial stocks in the UK at the end of 2008 found that the ban in the UK was ineffective at countering concerns about market volatility and resulted in damaging market quality, including widening of spreads, deterioration in market depth and reduction in liquidity. You will find attached as an appendix to this letter the detailed research (Appendix 2).

No need for further measures

We note, however, that CESR remains concerned about the practice, suggesting that “it can be used in an abusive fashion to drive down prices of financial instruments to a distorted level, can contribute to disorderly markets and otherwise have an adverse impact on financial stability” and will consider whether further measures for the regulation of short selling are required “to reduce or mitigate the negative consequences” beyond the disclosure regime discussed in this consultation.

We consider that there is currently no reliable evidence to support this view and that any measure to curb the activity would be an unfortunate development (e.g. price restrictions or ban – whether temporary or permanent – on the activity).

Proposed disclosure regime

With respect to CESR’s proposed disclosure regime, whilst we support the general principle of transparency in markets, we continue to believe that reporting of net short positions to regulators represents the best regulatory tool in relation to short selling. In contrast, a regime for public disclosure of short selling must carefully balance the benefits of transparency against the impact on market participants, the cost of compliance and the risk of creating a misleading impression in the market. We remain unconvinced that the current proposal will achieve the right balance between promoting greater transparency while not being detrimental to market efficiency.

We are concerned that the thresholds for private (and public) disclosure of net short positions envisaged by CESR are set at too low a level. The 0.10% threshold for private disclosure, in particular, will increase the administrative burden of market participants, while not necessarily providing meaningful information to regulators.

Similarly, we consider that the 0.50% threshold for public disclosure may not be proportionate and may harm market efficiency. This point is especially relevant, given that European regulators and CESR have not provided any evidence that short selling has led to any widespread problems in European capital markets.

As noted by CESR, short selling disclosure is a “greenfield” area. Therefore, should the current proposals be approved, we would encourage CESR to review

the regime after a short initial period and regularly thereafter and consider whether any amendments are warranted.

I hope that you will find our views useful and please do not hesitate to contact us should you have any questions in relation to the above.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'A Collett', with a stylized, cursive script.

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APPENDIX 1

Q1: Do you agree that enhanced transparency on short selling should be pursued?

As discussed in our letter, it is widely recognised that short selling contributes to a more efficient price discovery process and provides market participants with an effective hedging and risk management tool:

- Short selling allows negative information about a stock to be more fully reflected in the stock price: it will help to correct overpricing and provide more accurate valuation of companies. This is particularly important in bull market periods when short selling can dampen irrational overshoots.
- Short selling is widely used for hedging and risk management purposes. It may be vital in the context of capital raising of equity or equity-linked products (e.g. convertible bonds) as underwriters and investors may want to hedge part of their exposure in the company's stock in order to take part in the offering.

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We note from the consultation paper that CESR appears to be primarily pursuing enhanced transparency as a measure to constrain aggressive large-scale short selling. As emphasised above, we see short selling as an integral part of the efficient functioning of capital markets and we are concerned about the potential negative impact on market efficiency from the introduction of measures aimed at curbing the activity. Therefore, we do not believe that enhanced transparency should be used as a form of "circuit breaker".

Bearing that in mind, we accept that some measure of disclosure of short selling to regulators may be useful to regulatory authorities, for example in helping them to detect and deter market abuse or monitoring the orderliness of markets.

However, we are not convinced that enhanced public transparency would provide informational benefits to market participants and assist price discovery.

We believe that careful consideration needs to be given to the policy objectives that are pursued in devising any regime and we are not convinced that these objectives are clear.

Please also see our response to Q5 for our views on the characteristics of a transparency regime, including how they relate to policy objectives.

Q2: Do you agree with CESR's analysis of the pros and cons of flagging short sales versus short position reporting?

Q3 Do you agree that, on balance, transparency is better achieved through a short position disclosure regime rather than through a flagging requirement?

If a transparency regime is adopted, we agree with CESR's analysis about the pros and cons of flagging short sales versus short position reporting. Specifically, we consider that a system of flagging short sales would be extremely difficult and costly to implement both for market infrastructure providers and market participants, both domestically and on a pan-European basis.

IOSCO's principles on the regulation of short selling¹ are particularly relevant here; they require competent authorities to take into consideration the extensive costs and changes that would be required in order to implement a flagging system where one does not already exist.

A short position reporting regime is a better alternative in the European context.

Q4 Do you have any comments on CESR's proposals as regards the scope of the disclosure regime?

We support CESR's proposal as regards to the scope of the disclosure regime. In particular, we agree that the regime should be applied consistently to securities admitted to trading on Regulated Markets and MTFs. In our case, this would cover our Regulated Markets (e.g. the Main Market and the Specialist Fund Market in the UK and the MTA and MIV in Italy), as well as our junior markets (e.g. AIM and AIM Italia). We also agree that the regime should be limited to issuers incorporated in the EEA or with a primary or sole listing in the EEA.

Q5 Do you agree with the two tier disclosure model CESR is proposing? If you do not support this model, please explain why you do not and what alternative(s) you would suggest.

We have a number of concerns with respect to CESR's proposed two tier disclosure model.

¹ IOSCO Regulation of Short Selling – Final report

We accept that private disclosure to regulatory authorities may help regulators to detect and deter market abuse, although we have reservations about the level of disclosure thresholds envisaged by CESR (see our answer to Q7).

However, as stated above, we have concerns with respect to CESR's proposal to require public disclosure of short positions to the market. CESR's view is that this aspect of the proposed disclosure regime will not only provide informational benefit to the market, but also (and more importantly) act as a measure of deterrence to aggressive short selling.

In turn, we would like to re-emphasise the fact that short-selling is a legitimate investment technique and plays an integral role in efficient capital markets. We remain doubtful about the efficacy of a public disclosure regime to act as a "circuit breaker" and see risks to market efficiency from restricting market participants' ability to legitimately use short selling as part of their normal trading and investing activity.

Although we are convinced that it is not necessary to introduce any public disclosure system on short selling, we consider that, in any case, this information should be provided on an aggregate rather than on an individual basis. This would mitigate the risks to market efficiency, protect market participants' proprietary trading strategies and also limit the possibility of "short squeeze" and "herding" (which are discussed by CESR in the consultation paper).

In summary, we would prefer an alternative disclosure model, where private disclosure of individual short positions are made to the regulator, while public disclosure of short positions to the market are made on an aggregate basis only.

We consider that such a model would be more proportionate from a cost-benefit perspective, especially given that CESR has not provided any evidence that short selling has led to widespread problems in European capital markets. Such a model would also strike a better balance between achieving enhanced transparency without harming market efficiency.

Q6 Do you agree that uniform pan-European disclosure thresholds should be set for both public and private disclosure? If not, what alternatives would you suggest and why?

If, despite our view, a two tier disclosure regime is implemented, we would agree with CESR's analysis that a single threshold for both public and private disclosure should be introduced across Europe. This would reduce the scope for confusion, reduce the implementation costs and facilitate market participants' compliance with the short selling regulation, especially when they are operating frequently on a cross-border basis.

Q7 Do you agree with the thresholds for public and private disclosure proposed by CESR? If not, what alternatives would you suggest and why?

Our view is that the thresholds for initial disclosure, both public and private, envisaged by CESR are set at too low a level.

- We consider that a threshold of 0.10% for private disclosure will lead to frequent disclosures, quite possibly meaningless to regulators and very costly for market participants. We suggest that a threshold of 0.50% for private disclosure may be more appropriate.
- As explained in detail in our answer to Q5, we are concerned about the potential negative impact on market efficiency of mandating public disclosure of net short positions. To mitigate this, we would prefer a disclosure threshold of 1% instead of 0.50%.

We would not support a banded approach for subsequent disclosure. However, if introduced, we would base both public and private regimes on bands of 0.25% rather than 0.10% to ensure disclosures are meaningful and to reduce any unnecessary administrative burden on market participants.

Finally, we would strongly encourage CESR to be flexible and revise any thresholds that are set at the outset if and when required, as suggested by IOSCO in its final report on the Regulation of Short Selling¹.

Q8 Do you agree that more stringent public disclosure requirements should be applied in cases where companies are undertaking significant capital raisings through share issues?

Q9 If so, do you agree that the trigger threshold for public disclosures in such circumstances should be 0.25%

We do not believe that a lower threshold for public disclosures should be set in cases where companies are undertaking significant capital raisings.

We favour a single trigger threshold applicable in all circumstance to facilitate the administration of the scheme and ease the compliance burden on market participants.

In addition, we would like CESR to note that market participants, including underwriters of rights issues, will often use short selling as a tool to hedge their long exposure arising out of a rights issue. Measures to restrict the use of short selling risk reducing market participants' willingness to underwrite or take up a

¹ IOSCO Regulation of Short Selling – Final report

rights issue. This may in turn have the unintended consequence of restricting capital available to issuers.

Q10 Do you believe that there are other circumstances in which more stringent standards should apply and, if so, what standards and in what circumstances?

As noted above, we believe that uniform standards should apply in all circumstances.

Q11 Do you have any comments on CESR's proposals concerning how short positions should be calculated? Should CESR consider any alternative method of calculation?

We agree with CESR's proposals that the disclosures obligations should apply to net short positions, taking into account all relevant derivative instruments to create an economic view.

We believe that further analysis is required to determine whether disclosures should be made at group or legal entity level. In particular, there may be a need for differentiated rules depending on circumstances. Clearly, disclosure should be made at a fund level rather than group level in the case of a large integrated asset management firm; however, there may be circumstances where disclosure at the legal entity level may not be desirable (for example, if the legal structure of a number of group entities does not reflect their economic activity).

Q12 Do you have any comments on CESR's proposals for the mechanics of the private and public disclosure?

We do not have any specific comments in relation to CESR's proposed mechanics for reporting to regulatory authorities. However, as noted by CESR, we would encourage co-operation between the competent authorities of Member States to facilitate market participants' compliance with the regulations.

If a public disclosure regime of short positions is introduced, we agree with CESR's view that public disclosures should be made in a manner that ensures fast and non-discriminatory access to the information. This can most effectively be achieved via existing providers of market data services (for disclosures made under the Transparency Directive).

Q13 Do you consider that the content of the disclosures should include more details? If yes, please indicate what details.

We do not see the need for additional details in the proposed content of the disclosures.

Q14 Do you have any comments on CESR's proposals concerning the timeframe for disclosures?

We agree with CESR's proposals. In our view, it is essential that disclosure obligations apply to end-of-day positions only. It is a recognised practice of many firms providing important liquidity to the market to trade in-and-out of stock throughout the day, but with the aim of having flat positions in these stocks at the end of the day. Disclosure of intra-day positions would therefore not provide regulators or the market with meaningful information and would be unduly burdensome for providers of intra-day liquidity. Indeed, it could contribute to the creation of a misleading impression of the market.

Q15 Do you agree as a matter of principle that market makers should be exempt from disclosure in respect of their market making activities?

Q16 If so, should they be exempt from disclosure to the regulator?

Q17 Should CESR consider any other exemptions?

Market Makers are key providers of liquidity and, in line with our answer to Q14, we consider that they should be exempt from any disclosure obligations, including private disclosure to the regulator. We also note that such an approach is in line with the IOSCO's principle for the Regulation of Short Selling.¹

We do not currently envisage the need for any other exemptions. However, we would encourage CESR to ensure that the exemption for market makers is applied in a way that is sufficiently broad and consistent across all European Member States to ensure all forms of liquidity provision are captured (for example, the granting of the exemption should not be limited to firms registered as "market makers" by regulators or trading venues).

Q18 Do you agree that EEA securities regulators should be given explicit, stand-alone powers to require disclosure in respect of short selling? If so, do you agree that these powers should stem from European legislation, in the form of a new Directive or Regulation?

We agree that any short selling regime should apply to the unregulated as well as the regulated community.

¹ IOSCO Regulation of Short Selling – Final report

In adopting measures on short selling during the current financial crisis, Member states have used the powers available to them under existing domestic legal frameworks. In particular, some Member States have relied upon the market abuse regime as a mechanism for applying short selling measures.

We believe that such an approach is not suitable for the practice of short selling in terms of efficient price discovery, increased market liquidity, etc. Other Member States have used their conduct of business powers towards market participants to restrict and impose conditions on short selling and we consider this is more appropriate.

However, on the basis of the evidence provided, we believe that the most appropriate course is for development of a coherent policy based on European legislation in the area of short selling and we welcome CESR's initiative to achieve a harmonized approach to this issue. We suggest that it may be a suitable issue for inclusion in the MiFID Review.