

MEMORANDUM

TO: File No. S7-08-09

FROM: Sarah Casey Otte
Office of Commissioner Aguilar

DATE: April 28, 2009

RE: Meeting with Representatives of Chicago Board Options Exchange and
Rich Feuer Group

On April 23, 2009, William J. Brodsky and Lita Frazier of Chicago Board Options Exchange, and Peter Rich and Mitchell Feuer of the Rich Feuer Group, met with Commissioner Aguilar and his counsel, Sarah Casey Otte. They discussed, among other things, short sale restrictions, including the price tests and the circuit breaker approach, outlined in the Commission's proposing release titled Amendments to Regulation SHO, Rel. No. 34-59748. Representatives of Chicago Board Options Exchange also provided the attached materials titled "Short Selling Principles April 23, 2009;" "Finandium: Reworking principles for short-selling practices, April 2009;" and "IOMA/IOCA Annual Conference, Frankfurt, 21 April 2009: Reworking principles for short selling: The regulators' perspective by Michael Treip, FSA."

Attachments

Short Selling Principles
April 23, 2009

- To restore investor confidence, myths about short selling¹ must be dispelled - short selling is a legitimate, integral and critical part of the price discovery, which aids liquidity, and contributes to capital formation and risk management processes for the U.S. markets.
- To maintain the efficient and effective operation of our markets, short selling activity should be subject to a principles-based approach with reasonable controls. The principles espoused in the March 2009 Consultation Paper issued by the International Organization of Securities Commissions (IOSCO) are sound and should be maintained.
- The regulatory framework currently in place under Regulation SHO already contains delivery and close-out requirements, locate requirements, a naked short selling anti-fraud provision, order marking requirements and reporting provisions for certain short interest reporting. The principles behind these regulations should be maintained and the prohibition of abusive short selling should be vigorously enforced.
- Any regulation of short selling should have the objective of maintaining fair and orderly markets, not of preventing downward price adjustments.
- If an uptick rule (either based on a bid or last sale test) or circuit breaker is imposed, it must be structured to address abusive short selling and should not unnecessarily restrict legitimate short selling.
- If an uptick rule or circuit breaker is imposed, there should be reasonable exceptions that promote the efficient and effective functioning of the market including exceptions for bona fide market making and hedging activity, especially for options market makers.
- International coordination of the regulation of short selling is critical to the avoidance of regulatory arbitrage. This is particularly important with respect to appropriate exemptions, settlement discipline and disclosure requirements.

¹ The term *short sale* refers to any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller. In a *naked short sale*, no prior arrangement is made to deliver the stock at settlement. Not all naked short selling activity is abusive or illegal. *Abusive short sale* practices are illegal. Abusive short selling refers to short selling that is used to manipulate markets. For example, a person is not permitted to engage in a series of transactions to create actual or apparent activity trading in a security or to depress the security price for the purpose of inducing the purchase or sale of the security. Selling stock short and failing to deliver shares at the time of settlement with the purpose of driving down the security's price is also manipulative activity. Other examples related to market manipulation include short selling used in conjunction with insider dealing and selling accompanied by false rumors designed to encourage others to sell. These types of abuses are already prohibited by SEC regulations, which should be vigorously enforced.



FINADIUM

Reworking principles for short-selling practices

Josh Galper

Managing Principal

April 2009

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What is Finadium?

Finadium is a US-based research and consulting firm with two practices in the financial markets industry

- Securities finance, prime brokerage and custody
 - Securities lending and short selling
 - Collateral management
 - Exchange-traded and OTC derivatives
 - Bilateral and centralized clearing
 - Services for leveraged investors
- Frontier and emerging markets
 - Trading and custody
 - Pension and institutional fund activity
 - Partnerships with other service providers for broad-based marketing, strategy and product development projects

Presentation Preview

- **The legitimacy of short selling and its regulatory environment**
- **Opportunities for derivatives exchanges in securities finance**

Is short selling a legitimate market practice?

We say yes: short selling aids in price discovery while providing market liquidity

- We see no moral ambiguity in short selling provided that short sellers have borrowed the underlying security
 - No naked short selling
- The challenge for regulators is balancing individual liberty versus investor protection
- Critics of short selling are really arguing for much greater investor protection over individual trading liberties
- The US SEC recently released several possible market regulations on short selling
 - The SEC is clearly struggling with the exact question of protection versus liberty

How should regulators prioritize investor protection versus individual trading liberties?

Our view: public safety must be the priority for the effective functioning of financial markets

- Public safety ensures confidence, whether real or perceived
- Excessive short selling must be constrained to gain public confidence
- There are three ways to regulate short selling
 - Uptick rules
 - Circuit breakers
 - Disclosure
- Back to the SEC, who propose:
 - Return to an uptick rule
 - Circuit breakers
 - No mention of disclosure on an intraday basis
 - The current weekly disclosure regime leaves many ways to abuse the market

Short selling and securities lending are linked and should be regulated together

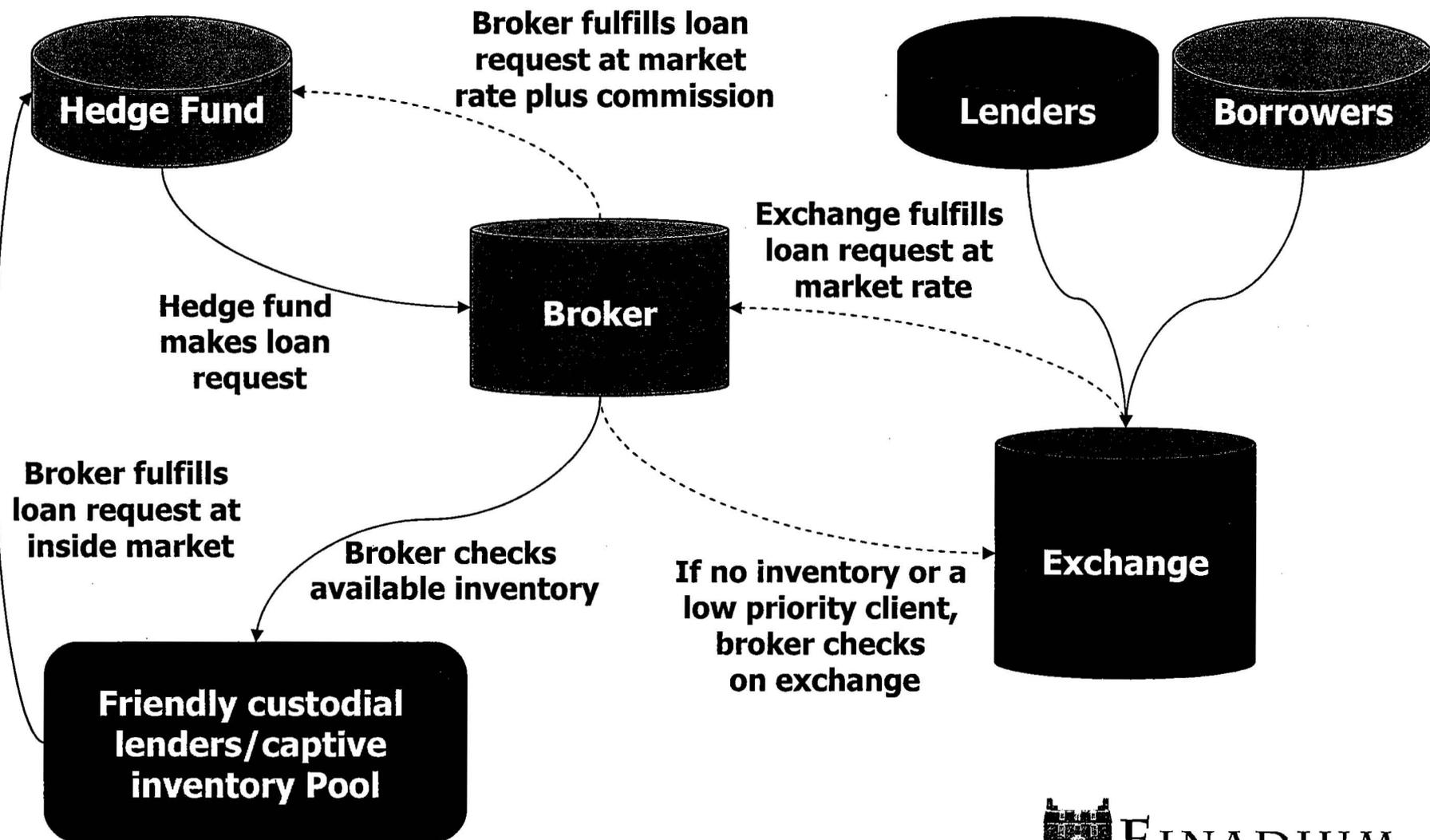
Financing for securities loans constitutes a market and can indicate future equity price movements

- Only a few regulators currently monitor securities lending activity
- Regulators are mostly active where the main clearinghouse runs a securities lending CCP service
 - Brazil is the best known example
- Securities lending is a huge market
 - There are roughly US\$2.5 trillion in assets currently on loan, down from \$4.8 trillion in 2007
- Securities lending and margin financing will generate \$6 to \$8 billion in fees for brokerage firms in 2009
 - Down from \$12 billion in 2007

A brief review of credit intermediation in OTC securities lending

Participants in the Securities Lending Market	
Pension Plan, Mutual Fund, Hedge Fund or Retail Investor – Calpers, Janus, Schwab	
Custodian – State Street, Northern Trust OR Goldman Sachs/Prime Broker	Lends at LIBOR less 15 bps
Prime Broker – Goldman Sachs, Morgan Stanley	Lends at LIBOR less 30 bps
Hedge Fund – 9000+ funds	Pays LIBOR less 30 bps

Securities lending on an “exchange”



Securities financing as a business opportunity for derivatives exchanges

Financing rates are an input into derivatives products and can become derivatives themselves

- There is a healthy arbitrage between securities lending rates and the implied interest in single and index equity futures
- Single stock futures and contracts for differences have the most explicit fees
- Hopes for vibrant securities lending “exchanges” hinge on cross-product arbitrage
- LCH.Clearnet, EuroCCP, Eurex Clearing the Options Clearing Corporation and Six X-Clear all offer CCP services for securities loans
- Various equity and derivatives clearinghouses allow for cross-product margining
- Collateral management is an add-on service

**IOMA/IOCA Annual Conference
Frankfurt, 21 April 2009**

**Re-working principles for short selling:
The regulators' perspective**

Michael Treip
Manager, Market Conduct, UK-FSA

Today's talk



- **The impact of short selling and the regulatory concerns it poses**
- **Regulatory work-streams currently underway**
- **IOSCO: The 4 Principles**
- **IOSCO: Reasons for the approach taken**
- **Emerging pan-European principles (CESR)**
- **Current thinking and timelines in the UK**

Impact of short selling



- A legitimate investment technique in normal market conditions:
 - a) Aids liquidity
 - b) Contributes to pricing efficiency

- Potentially negative issues arising:
 - a) Market abuse
 - b) Disorderly markets
 - c) Transparency deficiencies; and
 - d) Settlement failures

- In a climate of severe market turbulence and for firms engaged in rights issues, negative risks are heightened.

- But, restricting an investment technique with identifiable market benefits will inherently incur costs
 - Intervention only justified if there are **net** benefits

Regulatory work-streams underway



- **IOSCO Task Force:**
 - Consultation Report (March 2009)
- **CESR Task Force:**
 - Survey (September 08);
 - Call for evidence (December 08);
 - Two internal reports;
 - Likely consultation within 1-2 months.
- **National developments:**
 - UK; France; Australia; US.

IOSCO: The 4 Principles



- 1. 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.**
- 2. Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.**
- 3. Short selling should be subject to an effective compliance and enforcement system.**
- 4. Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.**

IOSCO: Reasons for the approach taken



- **Creating a ‘framework’ for international consistency**
- **Striking the right balance between the + and – aspects of short selling**
- **The nature of IOSCO:**
 - Consensus-based
 - Non-binding
- **The principles themselves**

CESR: Emerging pan-European principles



- **The need for contingency/emergency powers;**
- **Improved co-ordination;**
- **Convergence of regulation of short selling within Europe and internationally;**
- **Key issues to agree:**
 - Enhanced transparency: which model?
 - Legal basis
 - Identifying appropriate exemptions
 - Considering settlement discipline
 - Understanding the wider implications of regulatory intervention
- **Notable areas of divergence between IOSCO & CESR**

The UK-FSA's key proposals



Direct constraints: ✘

- i.e. blanket ban, ban of 'naked' short selling, specific/sectoral bans, circuit breakers, tick-rule etc.
- On CBA basis, considered **disproportionate**; but
- Emergency Intervention: ready to reintroduce a ban if necessary

Enhanced transparency: ✔

- Mitigate potential risks
- Informational benefits
- Justifiable on CBA basis
- Equal application across the market
- Public disclosure
 - Deterrent effect
 - Determination of thresholds
- Timelines