

ExpertPanel:



ASLA

Peter Martin

- Chairman of the Australian Securities Lending Association (ASLA)
- Vice president and head of securities finance Australia for State Street
- At State Street he manages the Sydney trading desk for both equities and fixed income with general oversight for all securities finance activities



ISLA INTERNATIONAL SECURITIES LENDING ASSOCIATION

Kevin McNulty

- Chief executive of the International Securities Lending Association (ISLA)
- Has worked in the securities lending industry for many years in the UK and US
- Prior to joining ISLA in August 2009, he worked for Barclays Global Investors where he ran the securities lending business in Europe and North America



PASLA PAN ASIA SECURITIES LENDING ASSOCIATION
Local Regulations, Global Standards

Zubair Nizami

- Executive committee member of the Pan Asia Securities Lending Association (PASLA)
- A second vice president and senior securities lending trader in Northern Trust's Hong Kong office
- Began his career at Northern Trust Hong Kong in March 2005
- Has approximately 6 years experience in the securities lending industry



rma THE RISK MANAGEMENT ASSOCIATION
Serving the Financial Services Industry

Chris Kunkle

- Director of securities lending and market risk at the Risk Management Association (RMA)
- Has previously held senior roles at Wachovia Global Securities Lending Group, J.P. Morgan and Mellon Global Securities Lending
- Also represented the securities lending industry with the Internal Revenue Services, the US Treasury Department and the SEC

Short selling was at the centre of heated debate throughout 2010 as regulators continued to take action in the form of bans and circuit breakers. **Fundamentals** interviewed four securities lending associations about the regulatory landscape in their respective countries.

Educating the regulator

What are you currently doing to educate regulators about short selling and securities lending?

PM: ASLA and its constituent members have been responsive to invitations from the Australian Securities and Investments Commission (ASIC) to discuss the benefits securities lending brings in promoting liquidity and efficiency within financial markets. One of the main initiatives is to seek additional exemptions to the current short-selling regulations such as defining liquidity to make it easier to operate in the Australian market. At present much business is being directed away from Australia, in markets such as Hong Kong, and that trend will continue unless we see change.

KM: Over the past year we have spent a lot of time with UK regulators (the Financial Services Authority (FSA) and The Pensions Regulator) helping them to understand more about how securities lending works. A particular focus was ensuring that the regulators gained comfort that the industry was doing enough to educate beneficial owners about the benefits and risks of securities lending. Along with a large number of trade associations including the National Association of Pension Funds (NAPF) we produced a series of guides aimed at helping trustees understand this business better. Regarding short selling we have been working closely with the Association of Financial Markets Europe (AFME) and the International Swaps and Derivatives Association (ISDA) to educate regulators and policymakers across Europe about the benefits of short selling. This has involved meetings with member state regulators, members of the European Parliament (MEPs) and EU Council officials. This week we are in Frankfurt and Rome and next week we're off to Strasbourg.

ZN: PASLA has always worked in close conjunction with other industry bodies to help promote securities lending and to provide an industry consensus on issues that affect the development of the securities-lending business. Our objective is not just to assist regulators but other market participants, such as stock exchanges, monetary authorities and the media about the benefits that the business can bring to the efficiency of capital markets. Our members are from a diverse group and represent a whole spectrum of market participants be it broker dealers, custodian agent lenders or industry vendors. As such we have a wealth of knowledge and understanding of the dynamics of securities lending at our disposal which is extremely beneficial when addressing various stakeholders' concerns regarding the business. We believe that education is a continuous process in order to help all stakeholders have a better understanding of securities lending. Our members

actively engage in industry events and conferences around the region and we maintain regular dialogue with regulators and exchanges to help promote best practices/regulations.

CK: In the US the RMA and SIFMA have been working together in 2010 to have quarterly outreach meetings, led on the regulatory side by the Federal Reserve Bank of New York, the SEC, the Options Clearing Corporation (OCC) and to some extent the Department of Labour. In these meetings we agendaise the main topics along with regulators' questions. The RMA co-managed the Annual RMA UNC Kenan-Flagler Academic Forum with the University of North Carolina in April on major educational papers around short-selling and securities-lending studies. It enables academics to have a forum to receive feedback on these papers before they're completed. The RMA has also educated the OCC and the NY Fed in our securities lending training classes over the last two years.

How has your approach changed since the events of 2008?

PM: ASLA's approach and objective has always been to provide a unified representation in regulatory and other issues relevant to its members. Since the short-selling ban was imposed by ASIC in September 2008, ASLA has engaged with ASIC on some of the unintended consequences of the short-selling ban, including lenders' rights to recall stock to cover a long sell so that it would not be deemed a naked short sell.

KM: One of the most significant developments for the financial markets post 2008 has been the increased volume of regulatory proposals coming from member-state regulators and the EU.

Whilst we continue to try and be proactive in promoting the benefits of securities lending and short selling with regulators, the reality has been that we've spent a huge amount of time reacting to proposals.

ZN: We haven't changed our approach drastically. Due to the heightened focus on short selling and securities lending, we have seen more requests to clarify business practices. In this regard, PASLA members were in active discussions with exchanges and regulators to help alleviate any concerns they may have had regarding some aspects of the business.

CK: We have had a lot more proactive communication with regulators since 2007. There's more open discussion and regulators can call us with questions and get a fair, non-biased answer. Regulators feel comfortable with calling members of the executive committee and there is open dialogue in our outreach meetings. We get a lot of calls from the NY Fed and the OCC. Although we rarely needed to communicate with them in the past, now we need to in order to give them the information they require to make the best decisions.

ASLA: At present much business is being directed away from Australia, in markets such as Hong Kong, and that trend will continue unless we see change



Do you think regulators sometimes have a tendency to think of short selling and securities lending in terms of black and white?

PM: Regulators make policy decisions which must be definitive. ASLA has sought to ensure that the regulators understand the increased administrative burden that some regulations put on the securities-lending industry. Over the past couple of years ASLA have made a concerted effort to demystify some of the misunderstanding pertaining to securities lending, the aim being to remove ambiguity and clarify exactly what securities lending is and how it benefits the financial markets as a whole.

KM: If by black and white we mean good and bad, the answer I think, is that virtually all believe they are good (for markets and investors), but many also believe there should be some form of regulation. Recent attention has been on short selling, an activity which we know gets a rather unfair hearing during market crises, and the reality is that politicians are driving the regulatory agenda here. The majority of policymakers do not support bans of short selling (although some support having powers to ban the activity in exceptional situations), but most support some form of regulation. The challenge for regulators will be to implement rules that meet their policy objectives, without substantially reducing the benefits short selling provides to the markets and its users, the investors and issuers. The industry is supportive of regulation that gives regulators information about the level of activity and sensible measures to ensure that uncovered short selling doesn't lead to unacceptable levels of failed settlements. The challenge for us is to try and persuade the policymakers that our proposals make sense.

ZN: It is not necessarily the case that all regulators think of short selling and securities lending as inextricably linked. Indeed there were various other stakeholders who may have had the same view purely out of a lack of understanding of how the business actually operates. Not all regulators implemented drastic changes to short-selling regulations during the global financial crisis. For example, Hong Kong already had a robust short-selling mechanism in place and, much to their credit, the Securities and Futures Commission (SFC) in Hong Kong did not feel the need to make any amendments to the existing regulations as they had kept them in good stead.

CK: Securities lending had some bad press but regulators have said they are understanding the issue and while cognisant of the business issues of the past two years, they feel that they understand the risks associated with the business. They can differentiate between short selling and securities lending.

They realise that things aren't black and white, but the hard part is understanding whether short selling supported securities lending or if it's an activity that's going to occur nonetheless.

How are you educating them about the nuances in the market, for instance the difference between naked and covered short selling? Or the difference between forcing broker dealers to borrow stock before executing a short (as in Australia) and allowing brokers more flexibility to execute shorts for their clients but penalising brokers if they fail to deliver (as in the US)?

PM: The industry's interpretation of RG 196 has generally been that a short seller must have a firm commitment from a lender prior to executing the covered short sale. Now that the market has stabilised, ASLA has initiated communication with ASIC to discuss whether it might consider a different test for covered short selling, such as an approved list of short-sellable products for which the borrow market is highly liquid and risks of settlement failure are minimal. Their interpretation of the regulations has been made very clear but it is their application that we seek changes to. Requiring the net short-sell position to be covered by close

of business as in other jurisdictions would allow a significant number of arbitrage transactions that are simply not feasible under the current regulations.

KM: Along with AFME and ISDA we are meeting with as many people as we can. We have also produced a number of briefing papers specifically aimed at MEPs who naturally do not have the same degree of technical understanding of these matters as market participants or securities regulators. Understanding how the US and Asian countries regulate short selling is important.

ZN: We believe that it is important that all stakeholders, be it regulators, the media or beneficial owners, understand that we do not condone abusive short-selling practices. To this extent we encourage regulations that help develop orderly, efficient and competitive development of markets around the region.

CK: We haven't had the issue of educating on short selling (either naked or covered) that much. We are educating on cash reinvestment, which is the most important thing right now for the US. We're also educating the clients, agent lenders and broker dealers. We're not getting hit by inflexibility in covering shorts because there is a system in place, along with regulatory requirements, where before broker dealers short, they know they can cover the security through various activities.

Is there a specific country's regulatory body that is leading the way in terms of short selling / securities lending regulations? Whereas the SEC was ahead in 2008, now it seems that the Japanese and Australian regulatory bodies

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are at the forefront of disclosure and transparency regarding short selling / securities lending.

PM: ASIC has been very thorough in its regulation of the Australian market in terms of securities lending and short selling and the market has responded to the increased administrative burden. The concern is that the increased regulation has reduced the level of activity that is now observed in the Australian market in comparison to other markets. At its peak in 2007 there was approximately \$80bn in Australian equities on loan, that figure is now \$15bn. If it is accepted that securities lending provides stability and liquidity to financial markets then given the low volumes of shares on loan one must assume this is detrimental to both the liquidity and efficiency of the Australian market. The stability of the regulations in Hong Kong has provided comfort to funds operating in that market and that is a driving force behind the increased transaction flow.

ASIC have certainly been at the forefront of introducing rules on disclosure and that is something other jurisdictions will be paying close attention to. One would expect this to be getting discussed on a global basis.

KM: It's hard to pick one that is perfect. Many in the market are comfortable with the Hong Kong market's disclosure regime and many are happy with the SEC naked short selling regulations. It's not however straightforward to assume that these can be imported to the European marketplace. For example the SEC buy-in regime for shares might work in the US but trying to impose a common buy-in framework across Europe with many different exchanges, central counterparties (CCPs), regulators and settlement conventions is very challenging.

Regulators are keenly aware of how other regulators around the world deal with subjects like short selling. The European Commission produced a table of regulatory measures in existence throughout the world when it published its draft set of regulations in September. The worry is that regulators assume that if the market can deal with rules in the US for example, then it must be able to do so in Europe. This may not be true and in addition there is a risk that regulators simply cherry-pick the most stringent requirements from different markets and bundle them together in a way which is very damaging for the market.

ZN: As mentioned earlier, the SFC was probably the stand-out regulator in the region. This is because it already had robust and effective short-selling regulations in place prior to the crisis of 2008. Our counterparts at ASLA are in close dialogue with the main regulator in Australia, ASIC, regarding the short-selling regulations and we are always on hand to assist our Japanese

counterparts in this regard as well.

CK: On the broker and agent sides, the SEC is looking to review their activities and the potential changes under Dodd-Frank. We're working on attempting to eliminate cost-basis transaction reporting with the Internal Revenue Service (IRS); presently this includes securities lending but we're working to address if that was the intention of the IRS. In the US the leading regulators are a combination of the SEC, the Federal Reserve and the OCC.

We know that there is coordination among the various securities lending associations around the world, but how much coordination is there between the regulatory bodies?

ZN: We understand that regulators often consult with each other as they develop markets and regulations and have done so for many years. One such recent example has been the coordination of regulators around the world as members of the International Organization of Securities Commissions (IOSCO). Indeed, the SFC in Hong Kong, in their role as Chair of the Task Force on Short Selling, took a leading role in the publication of a consultation report, Regulation of Short Selling in 2009, which outlined

several recommendations with regards to the regulation of short selling around the world. We at PASLA maintain a strong relationship with the SFC and we deal with them frequently as a key partner in our work across the region.

CK: We're having joint meetings with the executive committees of other associations. IOSCO has an international regulatory force that is composed of representatives from most major regulatory agencies in each country. Through that process, regulators are communicating with each other and short selling is one of many things they're looking at. If ISLA or PASLA wants us to be involved in a specific global topic, we'll offer our services or that of our executive committee or subcommittee.

What work are you doing to coordinate discussion regarding short selling among the various worldwide regulatory bodies?

PM: ASLA engages in discussions with other securities-lending associations around the world. A newsletter is produced and sent to other securities-lending organisations updating them on what has been happening in the Australian market. ASLA does not actively seek to engage in discussions with regulatory bodies outside Australia.

KM: Given the intent focus in Europe on developing a new regulatory framework for short selling, we have spent most of our time working with other trade bodies here. We have been working with AFME and ISDA since the second half of 2009, and are in the process of building a wider coalition of interested parties. We continue to communicate with the RMA

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and PASLA through calls, and meet with each other at our respective conferences.

ZN: By virtue of our close connections with other industry bodies such as ASLA, ISLA and the RMA, we host various industry events & seminars around the world that help formulate debate and consensus regarding short selling. We hope that with active participation in these events, all market participants will take heed of the positive attributes of short selling.

CK: The RMA is not presently working on discussions on short selling, which is now old news in the States. It does remain very active in Europe in which ISLA is very actively participating. The main area of focus for the RMA is how it is educating regulators both domestically and globally. We're asked to provide information for discussions around securities lending. For example, in our November interim white paper on proxy voting, academics are reviewing the numbers and metrics in the issues behind proxy voting when a security is on loan. This will be provided led by CSFME based on data from six different banks. We're trying to find out if it was a problem – we don't believe it was, but we're looking into it.

Chris Cox* admitted that the ban on short selling was one of the biggest mistakes he made during his time as chairman of the SEC. Has the SEC learned a lesson from this admission? Has it been internalised? Have other regulatory bodies picked up on this admission and do they say they will act differently in the future?

ZN: We are not in a position to comment specifically on the SEC's stance. However, it seems that most regulators that did impose short-selling restrictions have probably learnt a few lessons from the crisis. That being said there is still a lot of work to be done as an industry as there are a few jurisdictions in the region that still have some restrictions on short-selling activity. We at PASLA will continue to work closely with other industry bodies as well as regulators and exchanges to help formulate best practices.

CK: I hope the SEC will be willing to learn and listen. I don't get as many calls from the SEC as I do from the Fed. I hope that they would communicate with other people in industry before making a major change. If legislation comes in that stops all shorts, you would hope that the framework would be out there to support you. According to academics, the short-selling ban didn't work. Was the uptick rule known for always having worked? I understand that it didn't. It's important to have all your facts and engage with the financial markets so that you don't create further reaction down the line.

What lessons have the regulators learned from the 2008 crisis? What lessons have they learned from their responses

to it? What do they think worked well? What do they think didn't work?

KM: We hope that, with the benefit of time and some good academic research, regulators understand that short selling provides beneficial liquidity to markets and may be especially useful during a financial crisis. What was missing in Europe in 2008 was the fact that regulators had little insight into the level of short selling taking place. We hope that in future they will have more information and that this will help to allay fears and avoid knee-jerk reactions.

ZN: The main lesson learned from the 2008 global financial crisis should be that it is important not to panic and impose draconian measures to limit short selling whenever there is a major sell-off in the markets. Given the uncertain outlook of the global markets in light of the European sovereign debt crisis and slowing US growth, it is inevitable that we will witness some volatility in the markets again in the near future.

The global financial crisis was an unprecedented event in global markets and we hope we do not experience

such an event anytime soon. That said, global regulators worked their hardest to steer a path through a number of concurrent issues. If significant market volatility reoccurs, we hope that regulators will be able to reflect on the numerous academic studies recently published that have demonstrated that short selling helps add liquidity to markets and that evidence of falling prices is not solely a result of short selling.

CK: Regulators are understanding more about how the business works. For example, the Fed has been meeting directly with the RMA and SIFMA, the clients and the pension funds. Pension funds are not monitored by the Fed, but they give them feedback. The Fed has learned that it's good to open up communication, and they've involved the SEC in that too.

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*Under Chris Cox's leadership, the SEC imposed a three-week ban on the short selling of nearly 800 financial company stocks in September 2008 to "protect the integrity and quality of the securities market" and "strengthen investor confidence". But just a few months later Cox said that this decision was the biggest mistake of his role as SEC chairman. He has claimed he was under pressure from the Treasury secretary Henry Paulson and Federal Reserve chairman Ben Bernanke to take action, and that he did so reluctantly. They "were of the view that if we did not act and act at that instant, these financial institutions could fail as a result and there would be nothing left to save", Cox said. He left the SEC in January 2009 and was replaced by Mary Schapiro.