

European Commission Consultation Paper on Short Selling: ICFR Response

The International Centre for Financial Regulation¹ (the ICFR) recognises the importance of the Commission's Public Consultation on Short Selling (the "Consultation") and welcomes the opportunity to respond.

The ICFR aims to provide a fresh perspective on the challenges of regulating global markets. As a non-partisan organisation, with the support of both industry and government, we act as a catalyst for dialogue, thought leadership and scholarship in this critical area. We also support practical training initiatives to improve understanding among practitioners and regulators. Our job is to encourage dialogue that identifies best practice across the traditional financial centres in the Americas, Europe and Asia and embraces emerging and developing economies worldwide.

The ICFR is aware that there has been much analysis – both in the form of academic papers and in response to previous consultation papers – around the role of short-selling within the financial system, with the result that many arguments have already been well aired. It is not the intention of the ICFR to replicate these arguments where it is not necessary to do so, but rather to underline those areas that the ICFR believes require further careful consideration.

Since the decline of the markets in 2008, there has been both monitoring and restrictions upon the short selling of some equity stocks and their derivatives across Europe, and more recently upon certain debt instruments. Much research has shown that such bans and disclosure requirements have not necessarily arrested falling markets;² as such, any further steps to legislate must be preceded by a clear explanation of what such legislation is aiming to do.

The ICFR would further suggest that more investigation as to the "unintended consequences" of implementing such legislation is necessary. It would appear that no research to date has been able to show the beneficial impact arising from the restrictions that have been in place since 2008 within Europe; just as the initial bans, in the latter part of 2008, were imposed without any form of analysis, there is further suggestion that subsequent bans have been put in place again without sufficient prior understanding of the consequences of such actions.³

¹ Interest Representative Register ID Number: 22182003082-77

² For example, Oliver Wyman "The effects of short-selling public disclosure regimes of equity markets" (http://www.oliverwyman.com/ow/pdf_files/OW_EN_FS_PUBL_2010_Short_Selling.pdf), Beber and Pagano "Short Selling Band and Market Liquidity around the World: Evidence from the 2007-09 Crisis" (<http://www.csef.it/WP/wp241.pdf>) and Gruenewald et al "Emergency Short Selling Restrictions in the Course of the Financial Crisis" (<http://ssrn.com/abstract=1441236>)

³ For example, Wolfgang Münchau "Only a closer union can save the eurozone", *FT* 27 June 2010 (<http://www.ft.com/cms/s/0/c5708036-8214-11df-938f-00144feabdc0.html>)

It is not the case that all short selling – naked or covered – is abusive; academic studies have shown the harm that bans (and related disclosure requirements) appear to have had in price formation and levels of liquidity, particularly in relation to the equity markets.⁴ Furthermore, short selling is attributed with “tempering” asset bubbles; allowing “long buying” only may result in seemingly more optimism than is warranted in any one market, as market participants lack a means of showing when they consider assets to be over-valued.⁵ Collapses will tend to be harsher as a result. It may be that the European Systemic Risk Board should review the role of short selling in relation to asset bubbles and subsequent crashes, and any proposed legislation only implemented in light of such a review.

It is important to note the relationship between restrictions upon short selling and the debt issuance process. One expected consequence of an extension of restrictions into the sovereign debt market will be to increase the cost of issuing such debt in the future: outright bans will make it harder for market participants to manage risk effectively; furthermore, the subsequent negative effects upon liquidity and efficient price formation following such a ban in the markets will see investors requiring higher returns before they are prepared to buy such debt. Whilst this is not unique to the sovereign debt markets, it is important to recognise that restricting the market now may lead to increased costs for all Member States issuing debt in the future. Whether or not this is a price worth paying is a question that has not, to date, been answered.

The ICFR would echo the sentiments of many other respondents to previous consultation papers in underlining the importance of harmonisation in any future legislation. The current rules have been unilaterally decided by individual Member States, leaving market participants faced with permutations of rules almost, but not quite, achieving the same ends from market to market: the differences between jurisdictions complicate compliance for those who operate in multiple markets. This is far from acceptable given that current rules have been implemented on the basis that non-compliance may be considered market abuse.

Please find below the ICFR’s response to the groups of questions posed by the Consultation.

- (1) Which financial instruments give rise to risks of short selling and what is the evidence of those risks?
- (2) What is your preferred option regarding the scope of instruments to which measures should be applied?
- (3) In what circumstances should measures apply to transactions carried on outside the European Union?

The Consultation lists some potential risks of short selling: these include the potential for abuse, including the amplification of price falls, and information asymmetry. Furthermore, uncovered short

⁴ Clifton and Snape “The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange” (<http://img.iex.nl/iexprofs/images/2008-12-01ResearchEvidenceofShortSellingRestrictions.pdf>)

⁵ As discussed in Deutsche Bank Research on Short Selling, 17 March 2010 (https://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000255171.pdf) and Buttonwood “When markets go wrong”, *The Economist* 10 June 2010 (<http://www.economist.com/node/16322566>)

sales may increase the risk of settlement failures and price volatility. It has been argued previously that there is no difference between being long or short an instrument in terms of the risks that it poses to other market participants;⁶ there has also been little evidence shown that such risks are exacerbated solely because a market participant has sold an instrument short. Short selling has been shown to assist in the creation of orderly markets, by virtue of giving market participants an active means of displaying their belief that an asset is overpriced. Without it, asset bubbles can arise which will be all the more severe when they are popped.

Any restriction in short selling of any instrument should only be implemented after a thorough analysis of the consequences of such a move. The ICFR would suggest that the European Systemic Risk Board would be in a suitable position to review the role of short selling in relation to financial stability. Any proposed legislation should only be implemented in light of such a review.

Although it is unclear, to date, whether these rules serve to benefit European markets, practically speaking, if short selling requirements are in place, such requirements should apply uniformly to all instruments (that is to say, Option A should be applied). The more complicated the system, the more likely that rules will be fallen foul of – and given the implication of market abuse, a mistake could lead to severe consequences. The disparity between short selling rules between EU member states to date has been massively complicated and arbitrary, making it very easy to fall foul of the rules unintentionally.

In terms of trying to apply these rules to transactions carried on outside the European Union: in theory, all transactions in European financial instruments should be covered equally. However, in practice, this will prove almost impossible; enforcement of rules outside of the EU would rely upon full cooperation with competent authorities worldwide. The Commission should look to clarify precisely what it hopes to achieve in introducing such rules, and if trading occurring outside the European Union has the potential to affect the markets in the manner that the new legislation is attempting to eliminate, then these measures should apply extra-territorially in order to avoid instances of regulatory arbitrage.

The Commission must also consider the potentially negative effects of restricting trading activities at the expense of European investors. Given the relative ease of trading European equity and debt instruments outside of the EU, both on exchange and over the counter, it may be that non-EU investors will be able to carry on forbidden activities regardless of the rules governing the same stocks within the EU. For markets that rely upon non-EU investors (such as EU sovereign debt markets), limiting the ability of some investors to carry out hedging activities depending upon their geographical location may not only push market making offshore but also put European investors at a significant comparative disadvantage with their non-EU counterparts.

⁶ As discussed by the British Banking Association in their response to CESR's consultation on the Proposal for a Pan-European Short Selling Regime (http://www.bba.org.uk/content/1/c6/01/66/39/BBA_Response_-_CESR_Pan-EU_Short_Selling_Framework.pdf)

- (4) What is your preferred option in relation to the scope of financial instruments to which the transparency requirements should apply?
- (5) Under Option A is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?
- (6) Under Option B do you agree with the proposals for notification to regulators and the markets of significant net short positions in EU shares?
- (7) In relation to Option B do you agree with the proposals for notification to regulators of net short positions in EU sovereign debt (including through the use of CDS)? In addition to notification to regulators should there be public disclosure of significant short positions?
- (8) Do you agree with the methods of notification and disclosure suggested?
- (9) If transparency is required for short positions relating to sovereign bonds, should there be an exemption for primary market activities or market making activities?
- (10) What is the likely costs and impact of the different options on the functioning of financial markets?

The ICFR notes that neither option suggested in the Consultation mirrors that for the reporting of long interests in shares and equity-linked derivatives under the Transparency Directive. As mentioned above, it has been discussed previously that the risks of holding long and short positions are similar in nature. As such, the ICFR would suggest an option that, in certain respects at least, mirrors the requirements under the Transparency Directive for short positions in equity and equity-linked derivatives of those stocks admitted to trading on a regulated market in the European Union. There are some elements of the Transparency Directive that may not carry over to any short selling disclosure regime, most notably the initial disclosure threshold, which would need to be significantly lower than 5% to be useful in reporting short selling activity. However, given that research appears to have shown that there have been limited positive – and perhaps more negative – outcomes to the emergency disclosure requirement as discussed above, the differences between the two regimes should perhaps be compared and contrasted to ensure that there is a requirement to publish only the most useful information.

The ICFR would, on this basis, roughly support Option B, provided that the definition of shares included equity-linked derivatives; such requirements could be relatively straightforwardly aligned with those found in the Transparency Directive. However, should Option A be considered preferable, in trying to ensure the production of clear and valuable disclosures, the Commission may consider publishing further guidance on what is meant by “instruments which due to their nature cannot be the subject of short selling”, so that there is consensus on what must be reported.

There is anecdotal evidence from the initial implementation of short selling disclosure requirements in the UK in 2008 that a large proportion of disclosures made were considered to be incorrect in some manner as a result of insufficiently clear guidance, the speed of implementation and the short time frame for publishing; whilst measures to extend disclosure requirements to all stocks may eliminate some elements of doubt, it may be worth considering whether the speed of short selling position disclosures is more important than the quality of information in such disclosures. The

Transparency Directive requires disclosures to be made within five days of the transaction; it is generally not made public until later again. As there is no clear evidence that short positions are any more likely to be held abusively than long positions, there may be an argument that they should be disclosed on a similar time period, giving a proper length of time to calculate the holdings accurately. Having said this, it may be worth considering the UK's implementation of the Transparency Directive, which requires disclosure two days after the triggering transaction. Such a period of time is long enough to ensure correct calculation whilst informing the interested parties soon enough after the transaction has taken place. Time delays are apparent also in European trade reporting requirements, with large trades not being reported for several days; all the acquired evidence suggests that short selling does not pose sufficiently strong a threat to the market to need the information comparatively faster.

The disclosure of short sovereign bond positions (and associated credit derivative positions) is something that has not previously been done within Europe. As such, the ICFR would strongly recommend carrying out a full analysis of the perceived benefits of such a reporting regime, particularly given the costs that would be associated with implementing such reporting requirements. This would be extremely important as there has been no evidence to date that reporting such positions would aid competent authorities in finding abuse within these markets; indeed, recent reports have suggested that little to no analysis has been carried out on the activities of the sovereign debt markets during 2010.⁷ As argued previously, the relationship between the ability to short sell and the cost of issuing debt is an important one which will be strained in the long-term should the ability to short sell be impeded (research suggests that disclosure would also be considered an impediment).

Respondents to previous consultation papers have suggested that disclosure should be to the competent authority only; this could serve several beneficial purposes: as well as the potential for significantly reduced costs, the information would remain confidential, reducing the possibility of "herding" against a single market participant with a disclosed position, as well as allowing for protection against publishing strategies to the market. Furthermore, it could be argued that a more useful figure for the market would be the aggregate of short positions in one issuer rather than the individual positions of market participants.

Although the ICFR supports transparency as an essential means of effective regulation, any requirement of transparency in this context – whether for sovereign bonds or other issued instruments – must be thoughtfully and sensibly applied. This should mean exempting those market participants undertaking primary market activities and market making activities: the reasons that the Commission has set out in the Consultation for a disclosure regime is to ensure that there is a means of ensuring competent authorities can reduce abuse. Neither primary market activities nor market making activities are carried out on a proprietary basis, but rather as a result of the demands of other market participants. If disclosures are truly to be made as a means of limiting the possibility of abuse, including such positions would merely add "noise" and have the potential effect of detracting from those disclosures that do perhaps need further attention.

⁷ Wolfgang Münchau *FT* 27 June 2010, as above

- (11) What are the risks of uncovered short selling and what is the evidence of those risks?
- (12) Is there evidence of risks of uncovered short sales for financial instruments other than shares (e.g. bonds or sovereign bonds), which would justify extending the requirements to these instruments?
- (13) Do you agree with the proposed rule setting out conditions for uncovered short selling? Do you consider that more stringent conditions could be put in place? If so please indicate which ones?
- Do you agree that arrangements other than formal agreements to borrow should be permitted if they ensure the shares are available for borrowing at settlement? If so, why?
- (14) Do you consider that the risks of uncovered short selling are such that they should be subject to an upfront ban/permanent restrictions? If so, why?
- (15) Do you agree with the proposal requiring buy in procedures for settlement failures due to short sales? If so, what is an appropriate base period that could be specified before buy in procedures are triggered (e.g. T + 4)?
- (16) Do you consider that there should be permanent limitations or a ban on entering into naked credit default swaps relating to EU sovereign issuers? If so, please explain why, including if possible any evidence relating to the use of naked CDS.
- (17) Do you consider that in addition to the measures described above there should be marking of orders for shares that are short sales?
- (18) What is the likely costs and impact of the different options on the functioning of financial markets?

Responses to a recent FSA paper on short selling suggested that the major risk posed by uncovered short selling was that of settlement failure.⁸ This summary document written by the FSA concluded that, in the UK at least, settlement failure was not significant a problem to warrant further action around uncovered short selling. Whilst the UK may not be a useful example for all European markets, it does suggest that further legislation in this area may, in some cases at least, be unnecessary, particularly when there is little evidence that such short selling poses significant systemic risks (as discussed thoroughly above). It may be that some alternative method – such as requiring buy in procedures – may be a more proportionate means of controlling the risks, particularly as these procedures are not uncommon at present. The marking of short sale orders will practically be extremely difficult and costly to implement, for benefits that have not, to date, been clearly defined.

There is an argument that uncovered CDS positions may confer the holder with a direct means of influencing the cost of debt for the issuer that the CDS is written over, and as such some form of monitoring or restriction may perhaps be more appropriate here. This

⁸ Short selling: Feedback on DP09/1 (http://www.fsa.gov.uk/pubs/discussion/fs09_04.pdf)

argument is perhaps made more powerful given the fact that CDS are issued by third parties only; that is to say, there is no need to hold any instrument issued by the issuer in order to exert what could amount to significant influence. However, the ICFR would again stress that any decisions in this area should be taken after more thorough research into the role that uncovered CDS has played in creating market instability.

- (19) Do you agree with the proposed exemption for market making activities? Which requirements should it apply to?
- (20) Do we need any exemption where the principal market for a share is outside the European Union? Are any other special rules needed with regard to operators or markets outside the European Union?
- (21) What would be the effects on the functioning of markets of applying or not applying the above exemptions?

As the Commission itself notes in the Consultation, the role of market makers is crucial in providing liquidity. As such, an exemption from transparency requirements would ensure that those positions disclosed would largely be purely proprietary in nature, rather than positions taken on in order to facilitate client activities. Furthermore, a ban on uncovered short sales may serve to reduce liquidity, as it might restrain market makers who are obliged to make prices on instruments that they may well not own at any one moment during trading hours; not owning the stock at the moment of trading does not mean, of course, that they intend subsequently to fail settlement.

The operation of market rules outside the European Union will be extremely difficult to police. Presumably this would require an extremely strong network between competent authorities; any “extra-territorial” rules that are created would have to be applied universally to avoid regulatory arbitrage. Furthermore, it would surely not be practicable to apply rules created within the European Union where the home state does not have similar requirements; assessing the possibility of coordination at an international level should enable the Commission to assess whether such an approach would be feasible.

- (22) Should the conditions for use of emergency powers be further defined?
- (23) Are the emergency powers given to Competent Authorities and the procedures for their use appropriate?
- (24) Should the restrictions be limited in time as suggested above?
- (25) Are there any further measures that could ensure greater coordination between competent authorities in emergency situations?
- (26) Should competent authorities be given further powers to impose very short term restrictions on short selling of a specific share if there is a significant price fall in that share (e.g. 10%)?

The Commission should look to the outcomes of previous short selling bans before looking to implement rules allowing unilateral bans by the competent authorities of individual Member States. Whilst it may seem immediately sensible to have such rules in place, it would appear, through analysis of market reaction to the recent bans and disclosure, that such bans do not act to ameliorate problems in the markets – but rather appear to show a “last ditch attempt” to shore up falling markets.

One of the major flaws seen in restrictions to date is the failure of competent authorities to act in a coordinated manner. Coordination is necessary to ensure that regulatory arbitrage does not serve to undermine any unilaterally imposed ban. The proposals to require notification to ESMA and all other competent authorities would seem to reduce the potential efficacy of any such ban. Whilst it has been seen in practice that unilateral action is not the most effective method of implementing any emergency ban, there is surely a requirement for any ban to be quickly implemented if it is truly of an emergency nature.

Competent authorities should not be in the habit of stopping sharp drops in share prices. The market should, generally speaking, be able to price in disaster (for example, the recent fall in BP’s share price). It should be noted that short selling alone may not contribute to sharp falls in the share prices of individual stocks – or entire stock markets – and indeed, as discussed above, can reduce sharp falls through tempering asset bubbles. At least some of the main regulated markets within the European Union introduce some form of circuit breaker (whether a suspension of trading or placing the stock into an auction period) should a stock behave erratically; where these are in place, it does not necessarily follow that the competent authority should have to act additionally.

- (27) Should the power to prohibit or impose conditions on short-selling be limited to emergency situations (as set out in the previous section)?
- (28) Are there any special provisions that are necessary to facilitate enforcement of the future legislation in this area?
- (29) What co-operation powers should be foreseen for ESMA on an ongoing-basis?

Should competent authorities have such powers, they should only be used in emergency situations – and emergency should be defined in extremely strict terms. It may be more useful for competent authorities to be able to question specific transactions – as they currently do – to be able to target particular activities that look suspicious. ESMA's role in such an activity would be to ensure a uniform inquiry process as possible across all Member States. It should perhaps also, as suggested in the Consultation, perform periodic reviews of the role of short selling in the market.

- (30) Do the definitions serve their intended purpose?

The definitions do serve their intended purpose.