European Securities Markets Expert Group (ESME)

Position on Short Selling

Adopted by ESME plenary

Brussels, 19 March 2009

The European Securities Markets Expert Group (ESME) provides legal and economic advice to the European Commission on the application of the EU securities Directive. ESME was created by Commission Decision 2006/288/Ec of 30 March 2006 (OJ L 106, 19.4.2006, p.14).

The list of ESME members is available at:
http://www.ec.europa.eu/internal_market/securities/esme/index_en.htm

1. Executive summary

- *For at least 25 major equity markets worldwide restrictions on short selling were implemented in September 2008, the anticipated effectiveness of which have not been borne out by the evidence.*
- *In its analysis ESME emphasizes the lack of statistical evidence on the effectiveness of the recent measures and the serious uncertainties, compliance cost and burdens due to a lack of international consistency.*
- *Overall, short selling restrictions should only be applied in extreme circumstances as a short term response to a specific event; they should not be applied as a matter of course or as a regular feature of equities markets.*
- *Further consideration should be given as to whether there is merit, on a cost/benefit analysis, in the introduction of a disclosure or transparency regime.*

Short selling of equities has been faced with a negative image for many years: it is considered as driving down share prices by speculators thereby destabilizing vulnerable equity markets. Therefore, it has not been surprising, that supervisory authorities from at least 25 major equity markets reacted to the stock market crash mid September 2008 and implemented short selling rules, in some cases only in financial stock for their respective markets on very short notice.

However, it should be noted that the above effectiveness of the short selling restrictions has not been borne out by the evidence. As shown below, a number of recent studies on the impact of short selling restrictions have been published, all of which show that during their imposition volatility increased and spreads widened when contrasted with unrestricted stocks.

The ban on short selling especially in the financial sector did not prevent the consecutive crash in global equity markets which a newspaper merged into the quote: “You can ban short selling, but you cannot ban selling”[1]

According to common understanding, short selling is connected with falling stock prices. Surprisingly enough, the most obvious negative effect from short selling on recent markets – even becoming evident to a broad public – was the Volkswagen turmoil by the end of October 2008 – leading to rising shares prices and leading to huge losses with speculators being short the Volkswagen share, when the German car manufacturer Porsche revealed that it had achieved ownership on almost 75 per cent of the share capital of Volkswagen and the price of Volkswagen ordinary shares exploded from 200 to almost 1,000 euro within two days due to short sellers which were forced to close their positions. It could be questioned, whether such development could have been avoided – on top of a disclosure requirement for the synthetic Porsche long position (equity swaps) - for the benefit of markets as well as of investors by disclosure rules suggested in this position.

The temporary short selling rules across Europe and globally were set to expire at the end of December 2008. However, many regimes have been extended into 2009 as regulators

[1] See Daily Telegraph, 24 September 2008.

await the outcome of consultations on the future of short selling regulation. Regulators have also come under some political pressure to extend the temporary prohibitions on short selling.

The European Securities Markets Expert Group (ESME) has been asked by the Commission to evaluate certain aspects of short selling, including

- implications for possible market abuses
- effects of measures banning short selling in the markets
- temporary or permanent character of those measures
- need for coordinated action among national supervisory authorities.

According to that request the report starts with a review on the economic aspects of short selling. It focuses on the various empirical studies which have been published analyzing the effects of the various regimes since September 2008. Subsequently, various regimes will be highlighted, including an analysis comparing the differences among the present regimes and the differences to past regimes. However, the analysis shows, that even the same words have different meanings among different jurisdictions.

ESME's conclusions are that:

i) Short selling plays an integral part of the proper functioning of the equities market and is a legitimate investment technique.

ii) Permanent short selling restrictions are not necessarily effective as measures to address volatility and adversely impact markets and participants.

iii) Regulators should have the ability to impose measures in extreme market circumstances without the requirement for lengthy pre-consultation. Such prohibitions might on a short term basis serve as a cushion against sudden drops in share prices, and should therefore only apply as a last resort, especially in case of financial markets crises.

iv) There should be different levels of regulation, starting with restrictions on naked short selling.

v) However, the impact of such measures should be fully and carefully considered with respect to their market impact and appropriateness to the specific situation prior to their implementation. Furthermore, there should be proof of due process having been followed to ensure that the significant disruption to the market has been adequately considered, such that market participants have confidence in the steps taken.

vi) Any future rules and regulations should be based on a common international understanding of basic principles and technicalities. Since all major buy side and sell side firms count for a substantial part of the liquidity in the financial markets and are operating globally, it is imperative that short selling regulations – if any – are coordinated at a European as well as global level. The more deviations in such regulation exist among national jurisdictions, the higher will be the risk of adverse impact on the over all liquidity as a consequence as well as increased compliance and operational cost. Any future

common standard for regulations on short selling should not simply adopt the regime with the strictest standards already in place ("levelling up"), but should implement rules which are reasonable with regard to market efficiency and market protection. No regulation by a single Member State should be implemented before a common position among the EU institutions has been reached.

vii) Less interventionist measures may be more effective in addressing potential concerns regarding short selling (e.g. in the Porsche/Volkswagen situation cited above) and increasing market transparency. That one we would suggest for consideration is that of the disclosure of short selling activity. This could be achieved on an aggregated and anonymous basis and may provide useful information to both regulators and other market participants. As the implementation of disclosure rules is very onerous if it is done on very short notice, it should be discussed, whether it should be implemented as a permanent measure for increasing transparency on markets. However, prior to any implementation of rules more detailed research is necessary to allow for a consistent application.

viii) Any alternative measures should be considered on a ‘cost-benefit’ basis; for example, both “uptick” rules and the “flagging” of orders as short sales have been proposed, however, both are extremely costly and difficult to implement and further have not proven effective from either a cost or benefit perspective. Additional measures such as circuit breakers have also been suggested, however they suffer from practical drawbacks in a multi-execution environment

ix) Procedures for addressing late settlements would make markets operate more efficiently and address some concerns regarding the market impact of “naked” short selling. Consequently we would suggest that buy-in procedures should be considered with respect to trade settlements, as already in place in some markets.

2. Short selling – a theoretical and empirical perspective

2.1 Some theoretical aspects

- *Short selling in its pure essence only means the selling of shares, which are not directly owned by the seller when executing a transaction.*
- *Short selling should be viewed from the different angles of ensuring the settlement of securities transactions and influencing market and share prices.*

Short selling forms a core element of efficient financial markets, contributing to the equilibrium among spot, forward, option and swap markets for a certain share or for the shares of a certain country. Short selling in its pure essence only means the selling of shares, which are not directly owned by the seller when executing a transaction. As soon as the counterparty requires the delivery of the shares, the seller either has to have covered himself by having bought shares or by having borrowed shares. If the seller decides to borrow the stocks from a third party, this third party or lender inevitably refrains from selling the shares in the mean time. The lender expects a fee which compensates him for the fact that it is not able to sell the shares. By covered short selling the number of outstanding or tradable shares should remain unchanged; there are only shifts of ownership among investors.

With regard to the influences on markets and share prices the following arguments regarding short selling are normally presented for orderly markets:

- Increase in market efficiency by enabling investors to exploit market information in all ways
- Increase in market efficiency by facilitating arbitrage transactions among cash, futures and options markets
- Increase in liquidity with narrow bid-offer-spreads, especially regarding intraday trading
- Increase in turnover by additional transactions
- Potential revenue stream for long term investors with no intention to react on short term market changes
- Part of investment strategies in order to increase leverage for certain institutional investors (e.g. long-short strategies).
- Smoothing price excesses by short selling activities of institutional investors
- Need for efficient hedging in the derivatives market, thereby enabling the product range for investors
- Securing the settlement of securities transactions.

2.2 Short Selling and market abuse

- *The potential for providing access for market abuse is an element that applies equally to long purchases and short sales and therefore should not be considered unique or to addressed with respect to short selling alone. Additionally, it should be noted that the potential for market abuse is also dealt with by the Market Abuse Directive and related legislation.*

However, short selling can be used abusively (particularly where naked short selling occurs), and can contribute to disorderly markets. These types of risks are considered insufficient to warrant a ban on short selling, as the potential for providing access for market abuse, is an element that applies equally to purchases and therefore should not be considered unique to short selling alone. Additionally, it should be noted that the potential for market abuse is also dealt with by the Market Abuse Directive and related legislation. In addition, none of the recent studies quoted below have referred to that aspect.

We would agree with the FSA[2], that the "potential for abuse is greater for naked short selling relative to covered short selling. This is because for covered short selling the requirement to cover (e.g. borrow) inhibits both the speed and extent of short selling. The speed of short selling is constrained by the need to 'cover' the short sale before trading; and the extent of short selling is limited by the ability to borrow stock in the market. However, naked short sellers are not subject to those constraints; they can short as quickly as they can find willing buyers and can short sell over 100 per cent of the issued capital. Naked short sellers also have greater potential to give a false or misleading impression as to the supply of shares on offer for sales – as a naked short seller does not have the shares to sell at the time of sales."

2.3 Recent empirical evidence

- *The most recent empirical studies show that short selling bans have not lead to the expected share price behaviour, but negatively affected market quality.*
- *Obviously, the effects of short selling constraints could differ subject to the respective economic and legal environment as even small differences in legislation leads to deviations in market behaviour.*

Over the last couple of weeks some empirical studies have been published analyzing the effects of the present regime implemented by the supervisory authorities since September 2008.

- Ian Marsh, Norman Niemer: The Impact of Short Sales Restrictions, 30 November 2008[3]

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[2] FSA „Short Selling", Discussion Paper 09/1, February 2009, p. 11. See www.fsa.gov.uk/pubs/disucssion/dp09_01.pdf.

[3] Commissioned and funded by the International Securities Lending Association (ISLA), the Alternative Investment Management Association (AIMA) and the London Investment Banking Association (LIBA). See www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf.

- Matthew Clifton, Mark Snape: The Effect of Short-Selling Restrictions on Liquidity: Evidence from the London Stock Exchange, 19 December 2008[4]
- Ekkehard Boehmer, Charles Jones, Xiaoyan Zhang: Shackling Short Sellers: The 2008 Shorting Ban, 31 January 2009[5]
- Financial Services Authority: Statistical analysis: assessing the effects of the temporary short selling ban, 9 February 2009.[6]

While the Marsh/Niemer paper analyzes shares in the UK, US, Canadian, Italian, French, German, Swedish and Japanese markets, the Clifton/Snape paper refers to the London Stock Exchange and the Boehmer/Jones/Zhang paper to shares subject to SEC regulation. The FSA annex considered the returns, liquidity and volatility of UK shares that have been subject to the temporary ban in comparison to movements of the market as a whole. The papers compare banned shares after and prior to the implementation as well as the behaviour of the banned shares to shares not subject to the ban.[7]

According to Marsh/Niemer there was “no strong evidence that restrictions on short selling changed the behaviour of stock returns. Stocks subject to the restrictions behaved very similarly both to how they behaved before their imposition and to how stocks not subject to the restrictions behaved. Comparing behaviour across countries where the nature of the restrictions differed, the authors found no systematic patterns consistent with the expected effect of the new regulations, i.e. no evidence of a reduced probability of large price falls.”[8]

According to Clifton/Snape the spread in banned stock increased by 140 per cent from 15 basis points to 36 basis points, compared to a rise of 56 per cent from 13 basis points to 20 basis points in the non-banned stocks. Depth deteriorated in both control and banned stocks, though more drastically in the latter. It declined approximately 59 per cent for banned stocks and approximately 43 per cent for the control stocks, only. Trade and volume fell by approximately 10 per cent in banned stocks subsequent to the ban, while in control stocks the number of trades and share volume actually increased by 50 per cent. Turnover in banned stock fell by 21 per cent after the ban compared to a rise in turnover of 42 per cent in the control stocks.[9]

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[4] Commissioned by the London Stock Exchange and prepared by the Capital Markets Cooperative Research Center Limited.

[5] See for example www2.gsb.columbia.edu/faculty/cjones/shortingban.pdf. The authors are professors of the Texas A&M University, the Columbia Business School and the Johnson Graduate School of Management, Cornell University.

[6] See FSA, Discussion Paper 09/1, Annex 2.

[7] For a short analysis on the effects of the ban comparing restricted stocks and non-restricted stocks in the UK during the ban period.and subsequent market structures see also Laurent Boldrini, Marwan Abboud, Stanislas Bourgois, AES Analysis. The ban was lifted – but what about traders’ uncertainties? Credit Suisse Portfolio Strategy Market Commentary, 23 February 2009.

[8] See Marsh/Niemer, p. 24.

[9] See. Clifton/Snape, p. 2.

Boehmer/Jones/Zhang published almost the same results for the U.S. as Clifton/Snape for the London Stock Exchange: "The start of the shorting ban is associated with a sharp but temporary increase in share prices for affected stocks, consistent with most models of shorting constraints. Shorting activity drops by about 65%. Stocks subject to the ban suffered a severe degradation in market quality, as measured by spreads, price impacts, and intraday volatility."[10] "While the shorting ban is in effect, these market quality measures diverge wildly. Median effective spreads do widen from 35 to 57 basis points for the control stocks, but median effective spreads for the stocks on the initial ban list more than triple, from 42 to 145 basis points. … Stocks on the original SEC list experience a sharp increase in intraday range volatility during the shorting ban (an average 11.61 % for initial ban stocks vs. 8.19 % for control stocks."[11]

The FSA statistical analysis[12] has revealed results which are more or less in line with the above mentioned empirical analysis. Regarding returns the FSA states: "In the 15 days after we introduced the temporary ban restricted stocks performed better than the FTSE 350. However, in other periods average returns for the restricted stocks are generally in line with the returns on the FTSE 350 pre- and post-ban." Regarding the volatility the FSA has found that the results for the relative change in volatility of restricted stocks compared to the market are inconclusive. The traded volume for restricted stocks increased relative to the market immediately after the introduction of the temporary ban, followed by a marked decrease in trading volume. "Bid-ask spreads have increase market wide after the introduction of the temporary ban. However, spreads for the restricted stocks have risen considerably more than they have for the market as a whole."

The results were principally identical: the statistical data on the stock price did not show the expected outcome from the exclusion of pessimistic investors from the market, while market quality significantly suffered.[13]

"All the empirical evidence says shorting restrictions cause prices to be wrong, and the evidence here follows suit. In that sense, the SEC probably achieved its unstated goal of artificially raising prices on financial stocks. … Nevertheless, as we write in January 2009, it now seems much less likely that short sellers are to blame for the sharp decline in financial stocks."[14]

However, the quality of the analysis might be affected by the short period of observations, the extraordinary flow of economic and financial news during the period and the similarity of the regimes implemented by the respective supervisory authorities.

In addition to that the EDHEC Risk & Asset Management Research Centre published a short analysis titled "Will the Ban on Short Selling Help?" on 4 November 2008.[15] The pa-

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[10] See Boehmer/Jones/Zhang, p. 1.

[11] See ibidem., p. 14 to 15.

[12] See FSA, Discussion Paper, Annex 2, p. 1 to 2.

[13] See Marsh/Niemer, p. 24.

[14] See Boehmer/Jones/Zhang, p. 18 to 19.

[15] See www.edhec.com. The FSA published in its Discussion Paper 09/1 on "Short Selling" (pages 39ff.) a literature review.

per analyzes more than 15 empirical studies published in the academic literature, mostly over the last ten years.

Although the authors came to the conclusion that "the available evidence does not suggest that short selling is an impediment to well functioning markets", they admit that "Short sale constraints constitute a friction in financial markets. … The presence of short sale constraints is an impediment to informational efficiency and prices will not fully reflect all available information in the market. Based on this efficiency argument, financial economists typically tend to defend liberal rules on short sales. … To the contrary, recent theoretical models suggest short sale constraints may facilitate market crashes.

While there is ample empirical evidence for the theoretical predictions that short sale restrictions lead to inefficiencies, the empirical literature also contains mixed findings. There are several empirical papers that associate short sale restrictions with overpricing. Depending on their sample, different studies produce conflicting conclusions on the effect of short selling on volatility, liquidity and skewness."[16]

None of the studies start with a clear, precise definition as to what is considered as "short selling", especially where the situation in different markets and different jurisdictions are compared. Even the general definition which is posted in the beginning of this section is not sufficient for any detailed discussion, as market participants react differently to even slight differences in economic and legal environment. Therefore, it is extremely important to make sure that there is consent not only on the wording but also on the concrete content of the respective wording.

But that has not only been true for the economic effects on markets, but also on the action to be taken by the respective investors in order to comply with the respective regime.

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[16] See EDHEC, p. 3 to 4.

3. Regulations on short selling

3.1. The rationale behind the regulations

- *Followed by the action taken by the FSA and the SEC at least 25 major equity markets became subject to short selling restrictions in September 2009.*
- *Different objectives behind short selling restrictions: prevention of market abuse, improving settlement performance, proportionality and consistency.*
- *In the meantime, public consultations have been released to get more analysis on the implemented measures.*

After the turmoil in the financial markets, both the UK Financial Services Authority (FSA) and the US Securities and Exchange Commission (SEC) announced on Thursday 18 September that they would take temporary emergency action to prohibit short selling in shares of financial companies to protect the integrity of the securities market and to strengthen investor confidence. Many other supervisory authorities followed that step within the next days, so that more than 25 major equity markets became subject to short selling restrictions.[17]

The variety of measures imposed by different regulators both recently and historically reflects their different concerns for the markets in their jurisdictions and differing interpretations of the causes of market disruption.

The short selling restrictions that were in place prior to September 2008 were generally a response to circumstances affecting particular individual markets, so tend to take the form of price restrictions applicable to all listed securities rather than targeted bans on short sales of particular securities.

The measures introduced by regulators since September 2008 were intended to be temporary restrictions designed to stabilise the markets, and to be removed when no longer required. Regulators agreed that there was a possibility of damage to the markets as a result of abusive short selling. However they differed in their approach to limiting the possibility of this damage, with some regulators taking the view that in the context of emergency temporary measures, it would be best to halt short selling altogether, while others decided to require market participants to provide more information on their short selling activity, and to take further action if it seemed appropriate. The measures range from prohibitions on creation of net short positions (e.g. UK, Ireland, Netherlands); prohibitions on naked short selling (e.g. France, Germany, Italy) or even on covered short positions (e.g. Australia, South Korea); uptick rules (e.g. Taiwan, Canada); and enhanced disclosure requirements for stock sales or stock loans (e.g. Hungary). Even where regulators did not consider it necessary to make new rules, many of them made public statements indicating that they will closely scrutinise short selling to ascertain whether it is compliant with market abuse or other trading rules.

The UK FSA restrictions introduced in September 2008 focussed on preventing price manipulation and stopping people from driving down the prices of shares in vulnerable finan-

[17] For an overview of regulations see Clifford Chance, Short selling global review, various issues since September 2008. www.cliffordchance.com.

cial institutions. However in other countries (e.g. Singapore) the emphasis was more on preventing settlement disruption as a result of failed trades, and in a minority of countries (e.g. Hungary and Spain, where there was already a ban on naked short selling) the regulator has taken the view that there was no need to further restrict short selling and that the focus should be on increased transparency and disclosure requirements (for example, requiring investors to report short sales or net short sales positions to regulators, self-regulatory bodies or the public).

A number of regulators have stated that they consider short selling to be a possible indicator of market abuse and have introduced regulations or issued statements accordingly. However, it is necessary to ensure that measures designed to prevent abusive short selling do not also restrict important market functions such as securities lending and hedging, and several regulators have also issued statements clarifying that these measures have only been introduced as a temporary emergency response to unusual market conditions and that they do not consider short selling *per se* to be a form of market abuse.[18]

Hector Sants, the chief executive of the UK FSA said, in relation to the short selling restrictions imposed in September 2008:

"While we still regard short-selling as a legitimate investment technique in normal market conditions, the current extreme circumstances have given rise to disorderly markets. As a result, we have taken this decisive action, after careful consideration, to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector."[19]

In its Consultation Paper 09/1 on “Temporary short selling measures” the FSA has confirmed that view but illustrated three potential problems associated with short selling:

i) Market abuse: Short selling can be used abusively to create misleading signals about the real supply, or the correct valuation, of a stock and/or “scaremongering” to push down the price of a stock being shorted. …

ii) Disorderly markets: Short selling can convey a signal to the market that a firm is overvalued. … However, if investors respond irrationally (e.g in the context of a general lack of confidence in some financial services stocks) the price decline may be excessive (price overshooting) … Overshooting can become a self-fulfilling prophecy for firms in sectors experiencing stress, resulting in disorderly markets. …

iii) Transparency deficiencies: Information about the aggregate short position in a single stock could help the market judge the extent to which short selling is driving the price of that stock and the amount of overhang …”[20]

These views have been explored further by the FSA in its Discussion Paper 09/1 “Short Selling”, published in February 2009.[21] In addition to the aspects of market abuse, dis-

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[18] The following section only contains quotes published by regulators on their restrictions on short selling measures. ESME has not done any research in order to categorize or make a judgment on the respective reasoning.

[19] FSA Press Release 18 September 2008: www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml

[20] FSA, Temporary short selling measures, Consultation Paper 09/1, January 2009, excerpt from pp. 4 and 5.

[21] See www.fsa.gov.uk/pubs/discussion/dp09_01.pdf.

orderly markets and transparency deficiencies the FSA in addition refers to the vulnerability of a company undertaking a rights issue." This is because there is an incentive for short sellers to attempt to drive down the share price below the rights issue price so they can both: (i) profit from their short selling strategy; and (ii) bolster the supply of shares available for purchase (from the underwriters), thereby improving their ability to close out their short positions."[22]

With reference to an SEC emergency order[23] SEC Chairman Christopher Cox said, "The Commission is committed to using every weapon in its arsenal to combat market manipulation that threatens investors and capital markets. The emergency order temporarily banning short selling of financial stocks will restore equilibrium to markets. This action, which would not be necessary in a well-functioning market."[24]

In addition, the press release states: "This decisive SEC action calls a time-out to aggressive short selling in financial institution stocks, because of the essential link between their stock price and confidence in the institution. … At present, it appears that unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation. Financial institutions are particularly vulnerable to this crisis of confidence and panic selling because they depend on the confidence of their trading counterparties in the conduct of their core business."[25]

The president of the German BaFin, Joachim Sanio, was quoted "In the current market situation, short selling can drive financial companies into ruin,"[26] The Austrian FMA only referred to market abuse in connection with short selling[27], when publishing its implementing rules.

The resolution of Italian CONSOB "aimed at ensuring the transparency of the markets, the orderly conduct of trading and the protection of investors, believing it necessary to avoid that speculative manoeuvres, possibly entailing an anomalous reduction of prices of banking and insurance shares, are directed to Italian markets."[28]

The Swedish Central Bank and the Swedish FSA in their joint comments to the Commission's Consultation on Hedge Funds, however, stated that "Short-selling constraints make

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[22] See ibidem. p. 11.

[23] Securities Exchange Act of 1934 Release No. 34-58592/September 18, 2008.

[24] SEC Press Release 2008-211, "SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets", 19 September 2008, www.sec.gov/news/press/2008/2088-211.htm

[25] Ibidem.

[26] See dpa-AFX, BaFin untersagt Leerverkäufe von elf Finanztiteln bis Jahresende. 19 September 2008. ´In der derzeitigen Marktsituation kann Shortselling Finanzunternehmen in den Untergang treiben", sagte BaFin-Präsident Jochen Sanio.

[27] Press release of the FMA, 22 September 2008 („FMA schnürt Maßnahmenpaket zur Unterbindung markt-missbräuchlichen "Short-Sellings") www.fma.gv.at/cms/site/DE/presseaussendung_detail.html?channel=CH0055&doc=CMS1222097566525.

[28] Press release of CONSOB, 22 September 2008. www.consob.it/main/aree/novita/comunicato_20080923.htm.

it more difficult for financial participants to intensify negative market movements but it also makes it harder to protect long positions through short positions and to use arbitrage strategies. It is unreasonable to expect investors to refrain from speculating against mispricing in certain market conditions and that a large mispricing should be allowed to persist. Also, banning short-selling in stressed market conditions can have a negative effect on liquidity in a time when it is most needed. Hence, short-selling constraints will have a negative impact on market efficiency and price formation. Also, given that short positions can be mimicked by using financial instruments and derivatives, the effect from a constraint is obviously limited."[29] Therefore they requested for a thorough analysis to determine if there is a need for tighter market controls and rules on short selling.

In the meantime, the supervisory authorities have started processes to get a more profound view on short selling. The Committee of European Securities Regulators (CESR) has formed a dedicated task force on short selling, which will (i) assess the impact of the measures that were introduced by CESR members; (ii) consider the range of policy options for taking a more convergent approach; and (iii) enhance the coordination and cooperation between CESR members on the decisions adopted at national level. Base on the outcome of its preliminary enquiries, it has been mandated to analyse the impact of the temporary measures and to conduct further work with a view for achieving greater convergence between CESR members.[30] CESR has also released a call for evidence.[31]

On 10 February 2009, "the Dutch finance minister Wouter Bos told European finance ministers it would be worthwhile promoting 'international' regulations on short-selling, but stopped short of calling for a review of EU laws. According to the Commission, Bos said there needed to be more coordination of regulation at European level."[32]

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[29] See www.fi.se/upload/43_Utredningar/40_Skrivelser/2009/eu_hedge_funds_090203.pdf

[30] www.cesr.eu/popup2.php?id=5501

[31] See www.cesr.eu/index.php?page=home details&id=354

[32] See Huw Jones, EU ministers mull short-selling, bonus measures, Reuters, 10 February 2009. Similar see Boersen-Zeitung, 11 February 2009, p. 3, confirmed by verbal statement of the Commission.

3.2. Regulations on short selling since September 2008

- *An overview of the various regulations imposed by regulators show the differences among the various regulations.*

In late 2008 regulators became concerned that short selling may increase the potential for disorderly markets and introduced a variety of measures aimed at restoring stability to the markets. The US SEC and the UK FSA moved to ban short selling and require disclosure of short sales above a certain threshold. This move was followed by regulators around the world who also introduced restrictions on short selling.

In Europe the short selling restrictions took three main forms:

i) a restriction on the creation or increase of a net short position (e.g. UK, Ireland, Netherlands);

ii) a ban on naked short sales of physical shares (e.g. Germany, Italy);

iii) a ban on naked short sales of both the physical shares and financial instruments giving an economic exposure to the underlying shares.

However even within these categories there are significant variations in the restrictions imposed.

Affected stocks

Many regulators were concerned that financial institutions were particularly vulnerable to manipulation of the price of their stocks. For this reason, most of the recently imposed measures have focused on shares in financial institutions. In order to clarify the scope of the restrictions, regulators published a list of specified stocks to which the prohibition applied (e.g. UK, Belgium, France), or stated that the prohibition applied to shares in banks and insurance companies listed in their jurisdiction (e.g. Italy[33], Luxembourg). However, some regulators did not limit the application of the restrictions to securities listed in their jurisdiction: for example, the SWX-Europe restrictions also applied to certain UK listed securities, and the Canadian restrictions applied to specified securities dual-listed in the US and Canada.

There was also a divergence of opinion on whether the restrictions should apply to all trades in the affected securities, or only to on-exchange trades. Regulators including those in Portugal and Italy stated that their restrictions applied only to on-exchange trades, while other regulators (e.g. Ireland and France) applied the restrictions to over the counter trades as well as on-exchange.

Relevant instruments

Some restrictions (e.g. Germany and Italy) apply only to the physical shares in the specified institutions, while others apply both to the physical shares and also to financial instruments which give an economic exposure to the restricted shares. In all these jurisdictions a short position is only adequately covered if the seller will be in a position to deliver the securities on the settlement date. In most cases a stock loan will be sufficient cover, but deriva-

[33] At the beginning the measures in Italy were implemented only on financial stocks. Afterwards the measures were extended to all shares.

tives or convertible instruments will not be sufficient cover unless the seller can exercise an irrevocable conversion right and acquire the securities in time for settlement. However, in Italy the regulator stated that stock loans were not considered to be adequate cover for short sales of financial stocks[34], and shares which had been lent out should be recalled prior to the sale. Another jurisdiction where lent shares are not recognized for the purposes of a covered short sale is Denmark.[35]

In the jurisdiction where the restriction is on the creation or increase of a net short position, the net short position is calculated by netting off short positions in shares or other financial instruments (whether naked or covered) against long positions held by the seller. Shares held under a stock loan agreement are not considered to be a long position, so a borrower who sells borrowed stock will create a short position.

Some jurisdictions (e.g. France) supplemented their restrictions by including a prohibition on measures designed to circumvent the restrictions.

Restrictions on stock lending

While several jurisdictions (e.g. UK) asked stock lenders to be vigilant and report any stock loans which they suspected might be for the purposes of prohibited short selling, a minority of regulators (e.g. France) went further and specifically requested stock lenders to abstain from lending the affected stocks. The restrictions imposed by other regulators (e.g. Italy) requiring stock which has been lent out to be recalled prior to sale had the effect of restricting stock lending, as it proved almost impossible in practice to comply with this requirement. In order to ensure that they had adequate cover and did not breach the ban on naked short selling, sellers avoided lending out the affected stocks.

While the restrictions in Europe focused on naked or net short sales, some regulators (e.g. Australia) also introduced a ban on covered short sales.

Certification from Clients

While most intermediaries developed procedures to make investors alert about the new regulations, in some jurisdictions formal requirements were applied to obtain written confirmations prior to the transactions. In Spain, stock exchange members were required to obtain written confirmations from their clients (and in case the “client” was another broker trading as an agent, the requirement was passed on to such broker) and in France, investment firms were also required to obtain prior written consent.

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[34] http://www.consob.it/mainen/documenti/english/resolutions/res16765.htm.

[35] Kredittilsynet, Executive Order no. 1004 of 10 October 2008.

3.3. Regulations on short selling prior to September 2008: some historical examples

- *The United States has had measures in place against short selling since 1938, including an uptick rule which was repealed in 2007 following a pilot program which removed price restrictions for a limited number of stocks, and indicated that price restrictions may facilitate over-pricing and are not required to prevent market manipulation.*
- *The Hong Kong Exchange introduced permitted covered short selling for a limited number of stocks in 1994. This regime remains in place and the list of permitted stocks is published quarterly.*
- *Naked short selling has been prohibited in Spain since 1967.*
- *Taiwan had an uptick rule for short sales, subject to an exemption for retail investors where the short sale was flagged. This was lifted towards the end of 2007, but re-imposed in October 2008.*

Several jurisdictions had restrictions on short selling in place prior to September 2008, and had done for a number of years. These jurisdictions include the United States, Hong Kong, Spain and Taiwan, amongst others. A brief description of the restrictions in these jurisdictions is set out below. This is not intended to provide a complete overview of pre-existing and historical short selling restrictions, but rather a summary of the different types of short selling restrictions which have been implemented in the past, by way of comparison with the recently introduced short selling restrictions.

The restrictions in place in these jurisdictions illustrate different approaches to short selling regulation: price restrictions in the form of an uptick rule (US); permitted short selling of selected stocks (Hong Kong); ban on naked short selling (Spain); and a requirement to flag short sales (Taiwan).

US

The Securities Exchange Act of 1934 was amended in 1938 to include Rule 10a-1, which provided that, subject to certain exceptions, a listed security could only be sold short (i) at a price above the price at which the immediately preceding sale was effected or (ii) at the last sale price if it was higher than the last different price. This procedure was known as the 'tick test'. The intention of the SEC in introducing the tick test was to prevent short sellers from accelerating a declining market[36].

In October 2003, the SEC proposed Regulation SHO, which was intended to consolidate the SEC rules on short selling and the rules imposed by various self-regulatory organisations (including the stock exchanges). As part of this proposal, the SEC suggested replacing the tick test in Rule 10a-1 with a price test, using the consolidated best bid as the reference point for permissible short sales[37]. However in the end the SEC decided to defer consideration of this issue. Apart from the introduction of various exceptions to accommodate changing market practice Rule 10a-1 had changed very little since 1938.

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[36] Exchange Act Release No. 1548 (24 January 1938), 3FR 213 (26 January 1938).

[37] Lofchie

In 2004, the SEC ran a pilot program, exempting a third of the stocks in the Russell 3000 index from all price restrictions. The pilot program ran from May 2005 until August 2007[38]. The SEC observed the effects of this pilot program on the markets and concluded that price test restrictions were no longer required in today's markets, as real-time surveillance and increased transparency mean that market manipulation through short selling is easily detected. As a result, the SEC repealed Rule 10a-1 in 2007.

Hong Kong[39]

The Hong Kong Exchange introduced a pilot scheme for regulated short selling in January 1994. Under the pilot scheme, 17 securities could be sold short and a short sale could not be made below the best current ask price, with limited exceptions for Exchange Traded Funds (the "tick rule"). The scheme was revised in March 1996 with the number of designated securities for short selling increased and the tick rule abolished. The tick rule was reinstated on 7 September 1998 upon changes in market conditions following the Asian financial crisis.

Prohibition on naked short selling: Naked short selling is not permitted under section 170(1) of the Securities and Futures Ordinance, which states that a person shall not sell securities at or through a recognised stock market unless at the time he sells them (i) he has or, where he is selling as an agent, his principal has; or (ii) he believes and has reasonable grounds to believe that he has or, where he is selling as an agent, that his principal has, a presently exercisable and unconditional right to vest the securities in the purchaser of them.

Section 170 also sets out exemptions from the prohibition on naked short selling (i) where a person acts in good faith on their own behalf or on behalf of another person, believing and having reasonable grounds to believe that they or the other person have a right, title or interest to or in the securities which they sell; (ii) where an exchange participant acts as principal in the course of his business of dealing in odd lots of securities in accordance with the rules of the recognised exchange company which operates a stock market; (iii) a sale of securities effected pursuant to a transaction in an options contract traded on a recognised stock market; and (iv) a sale of securities falling within a class of transactions prescribed in rules made under s.397 of the Securities and Futures Ordinance.

Restriction on covered short selling: Covered short selling is permitted only for certain designated securities, as prescribed by the Stock Exchange of Hong Kong Ltd ("Exchange"). The Exchange publishes the list of designated securities for short selling on a quarterly basis.

The Exchange defines a "short sale" for the purposes of the restriction on covered short sales as the sale of a security where the seller has a presently exercisable and unconditional right to vest the security in the purchaser by virtue of having (i) borrowed the securities under a securities borrowing and lending agreement, or obtained a confirmation from the counterparty to the agreement that the counterparty has the security available to lend to him; (ii) title to other security which is convertible into or exchangeable for the security to which the sale relates; (iii) an option to acquire the security to which the sale relates; (iv) rights or warrants to subscribe to and to receive the security to which the sale relates; or (v) entered into an arrangement under s.397 of the Securities and Futures Ordinance.

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[38] The SEC's study comparing market statistics for pilot and control stocks before and during the pilot program is available at www.sec.gov/news/studies/2007/regshopilot020607.pdf.

[39] www.hkex.com.hk/tradinfo/regshortsell/regshortsell.htm.

However, a sale will not be a short sale (and so will not fall within the prohibition on naked short selling or the restriction on covered short selling) where the seller has, at the time of the sale, issued unconditional instructions to obtain the security to which the sale relates.

In order to conduct a permitted (covered) short selling transaction, an exchange participant must provide his agent with an assurance, in the form of a document, that he has a presently exercisable and unconditional right to vest the security in the purchaser.

Uptick rule: In addition, short selling may be executed only on the Exchange's trading system at or above the best current asking price.

Breaches of the prohibition on naked short selling, restriction on covered short selling or the uptick rule may result in criminal prosecution.

Requirement to flag short sales: Exchange participants must also indicate that an order is a short selling order when inputting it into the system.

Spain

Under article 64 of the Stock Exchange Regulation, regulated market members are prohibited from entering into naked short sales. A naked short sale is defined as one where the seller does not hold the relevant securities at the time of the sale. The securities may be held by means of (i) previous purchase; (ii) stock loan agreed before the sale; or (iii) irrevocable exercise of a convertible security or physically settled financial security. Article 39 of the Securities Markets Act also entitles regulated market members to make compliance with client orders conditional on confirmation that the client holds the securities before processing their orders to sell, either by relying on their own registers if they act as custodian for the client or by obtaining the explicit assurance of the client that they are not conducting a naked short sale.

Taiwan

Prior to May 2005, there was an up-tick rule in place in relation to short sales of stocks listed on the Taiwan Stock Exchange and GreTai Securities Market, although an exemption from the price restriction was available for retail investors where a short sale of borrowed constituents was identified by making a number 6 tick on the sell order.

The up-tick rule in relation to the Taiwan 50 index was lifted with the approval of the Financial Supervisory Commission in May 2005[40]. From November 2007 the constituent stocks of the Taiwan Mid-Cap 100 index and the Technology Index were also exempted from the up-tick rule[41]. However, stocks which were not components of the Taiwan 50 Index, the Taiwan Mid-Cap 100 index or the Technology Index were still subject to the up-tick rule.

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[40] www.twse.com.tw/en/investor/foreign_invest/OCFID_06b.php.

[41] www.reuters.com/article/pressRelease/idUS83561+10-Apr-2008+BW20080410.

4. The need for international consistency: consent on wordings and technicalities

- *Since all major buy side and sell side firms count for a substantial part of the liquidity in the financial markets and are operating globally, it is imperative that short selling regulations – if any – are coordinated at a European as well as global level.*
- *The more deviations in such regulation between national jurisdictions, the higher risk of adverse impact on the overall liquidity as well as increased compliance and operational cost.*
- *Importance of clear definitions – also in relation to any exemptions – and a coherent position in relation to disclosure and reporting requirements for the confidence of market participants.*

In addition to their differing views on the measures required to restore order to the markets, the various regulators have also adopted different interpretations for some of the key terms used in the restrictions. For example, they have taken different views on what constitutes 'naked' short selling, on what disclosure might be required, and also in defining terms such as 'market maker' in relation to relevant exemptions.

The need for international consent results from the variety of trading opportunities. For many major shares a dual listing on organised markets in different countries exist, while others can be bought and sold via different trading channels. As national regulators can only supervise their own legal jurisdiction, it might be the case that trading in a certain share in jurisdiction A is restricted in a certain manner, while it is restricted in jurisdiction B by a different manner, and subject to no restrictions in jurisdiction C. Although the supervisory bodies of the home country (and normally the most liquid market) might have the decisive influence, it cannot be excluded that distortions might happen.

The target group for any short selling restrictions and disclosure regimes, however, is primarily large institutional investors, which have the financial resources to speculate against falling share prices. One of the major and most evident experiences from the developments during autumn 2008 is that such investors as well as intermediaries had to spend a substantial amount of time and effort in keeping track of the new rules as they constantly evolved.

Obviously, it should be recognised that the rules were introduced with short notice to meet an urgent need to mitigate potential negative effects in distressed market conditions. Still, the lack of coordination between supervisors and regulators caused substantial practical problems to institutional investors and intermediaries, as well as enhanced legal and regulatory risk. An example of the latter is that firms quickly developed a practise to circulate unilateral declarations between themselves (as well as to clients) stating that all counterparties/clients were considered as having confirmed their compliance with the short selling rules. For clients trading through Direct Market Access (DMA) this was often done by putting a legend with the same language directly in the technical DMA-facility.

A lot of highly appreciated initiatives were taken to provide guidance to those subject to the rules, such as the initiative from CESR to track and present the developments in individual member states, as well as number of more substantial initiatives from certain law firms and banks. However, as also emphasised by Clifford Chance in its regular updates on short-

selling[42], any firm subject to the rules could not rely entirely on such guidance, since they had to understand the details of the requirements in each country where they were trading. Some regulators also responded to specific identified issues by issuing Q&As on their web sites, however this practise was applied by a minority of the rule makers only, and in a few instances only in the local language (for example Italy which only published the Q&A paper in the Italian language). Hence, the market participant had to live with a substantial amount of legal uncertainty because (i) the content of specific local regulation was ambiguous and (ii) no guidance whatsoever was provided by the regulators on how the regulation should be construed.

Consequently, any party subject to the short selling rules had to do a detailed due diligence on the regulation in each country where it was trading shares, and this exercise became even more complex since the rules continuously were subject to rapid changes.

To summarize the need for European – or even global – coordination, investors should not be forced to analyse in depth the specific regulations including potentially different interpretation for each jurisdiction separately: there should be a common understanding. As a minimum, transparency is needed in this respect: for an international investor base, all authorities should additionally publish all materials in English language.

Therefore no further regulation by single Member States should be implemented prior to a common understanding among the EU institutions and the Member States.

Set out below are the various areas that should be considered with respect to harmonisation.

Naked short selling

The definition of 'naked' short selling, including the instruments and degree of ownership required to give sufficient cover for a short sale, varies between the different jurisdictions. Most of the European jurisdictions provide that a sale will not be a 'naked' short sale if the seller owns the relevant securities or has entered into an agreement that entitles him to receive the securities before the settlement date of the sale. Most jurisdictions consider securities borrowed prior to the sale under a stock loan to be adequate cover, however they vary regarding whether the requirement is simply for a 'locate' or whether an agreement to borrow is required. There is also disagreement over whether stocks which have been lent out must be recalled prior to entering into the sale, or whether it is sufficient to recall them following the sale, provided they are available in time for settlement.

The Spanish regulator stated in its FAQs that a sale would be considered to be covered where the seller has borrowed the securities or exercised an irrevocable conversion right, option or any kind of derivative instrument with physical delivery. The French regulator required in its Press Release of 19 September[43] that any investor giving a sell order for one of the specified securities must hold 100% of the securities to be sold on its account with its financial intermediary. Securities held under a stock loan will be sufficient cover.

The German regulator requires the seller to own the shares or to have an "unconditionally enforceable legal claim" for the transfer of title in the shares. An "unconditionally enforceable legal claim" will exist where the seller has an existing and enforceable claim not

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[42] See Clifford Chance, Short Selling global review.

[43] www.amf-france.org/documents/general/8424_1.pdf.

subject to any rights of the counterparty to reject or repudiate such a claim. This includes securities held under a stock loan where the loan agreement was concluded prior to or at least simultaneously with the sale. There is no requirement to have the securities booked into the seller's account prior to the sale.

The Italian regulator requires sales of financial securities to be supported, from the moment of the order up until the date of the settlement of the transaction, by both the availability and ownership of the relevant securities. Securities held by way of a stock loan will not be considered to be available by the borrower.

While most regulators agree that a stock loan is adequate cover for a short sale, there is less clarity in relation to other instruments. Some regulators (e.g. UK) have listed examples of instruments which they consider will fall within the prohibition, or which will constitute 'cover' for a short position. However, as it is not practical to list every instrument whose value might depend on the price of restricted stocks, or every way in which an investor might own securities or an interest in securities, it will be necessary to consider how 'naked' short sales should be defined for the purposes of any more permanent restrictions.

It would also be useful to consider how any permanent restrictions would apply to a range of instruments, including scrip dividends, convertible bonds, depositary receipts, contracts for differences, spread bets and baskets or indexes.

We would suggest to define that:

- “naked” short selling should be considered as the sale of stock without any provision having been made for settlement purposes at the time of sale, and that
- “covered” short selling should be considered as the situation where provision has been made for settlement at the point at which stock is sold. Such provision would include the existence of a stock lending relationship and the general availability of relevant stock.

Circumstances in which rules are applied

Regulators should have the ability to impose measures in response to extreme market circumstances and this should be without the requirement for lengthy pre-consultation. Although this position does not explicitly define what market scenario should be considered as “extreme market circumstances”, restrictions on short selling should not be imposed under a scenario of falling share prices, but under an extraordinary market or crash scenario only. However, such measures should be fully and carefully considered with respect to their market impact and appropriateness to the specific situation prior to their implementation.

The enactment of such measures should be supported by proof of due process having been followed to ensure that the significant disruption to the market has been adequately considered, such that market participants have confidence in the steps taken. Where possible, and where practicable in the circumstances, regulators should co-ordinate the application of the rules to avoid the situation experienced recently where various regulators imposed differing rules at different enactment dates with varied requirements and with inconsistent expiration dates.

Products covered

Some regulators applied a concept of prohibiting aggregate net short position, taking into account transactions in all kinds of financial instruments (e.g. UK). Other regulators took a more narrow approach, counting in – in principle – only transactions in the equity cash markets (e.g. Norway, Denmark and Iceland).

Consideration should be given as to whether regulations should cover physical stock trading only or whether it should also include synthetic exposures (e.g. derivatives). The application was inconsistent with some regulators including derivatives whilst others did not.

The application of the rules to a specific sector should also be considered; whilst most regulators prohibited short selling only in financial stocks, other regulators extended the prohibition to shares issued by all companies admitted to trading on a regulated market (e.g. Italy).

Within this category the application to index or basket trades should be considered. Market participants faced significant uncertainty with respect to this area, particularly with respect to pan-European indices and indices including both financial and non-financial stocks. In certain jurisdictions index trades were permitted, whereas they were not in others. Consistency also needs to be considered with respect to independent established baskets/indices and bespoke baskets. Whilst regulators should have powers to address "avoidance" measures with such products, independent established indices should be permitted whether in exchange traded or OTC form.

Venues covered

Consideration should be given to which trading "venues" are covered; again major differences were evident, with some regulators including OTC and exchange traded products and some including only exchange traded products. The development of "Smart Order Routing"-facilities should also be taken into consideration. Smart Order Routing is basically a feature that facilitates automatic routing of orders to the venue where an order can be executed on the most favourable terms. Such facilities are a standard phenomenon in today's markets, and close to a necessity in an environment where one and the same share can be traded simultaneously on a multiple of trading venues, and in a regulatory environment where firms have to consider (and in hindsight demonstrate fulfilment of) best execution requirements. Again, in such environment, international consistency is the buzzword if short selling prohibitions, in any form, are to be considered.

Disclosure rules

In general, disclosure rules imposed by European regulators, if any, require disclosure of a net short position in excess of 0.25% of the issued share capital of a specified company, although the Belgian and Portuguese regulators also require a report to be made on a gross basis. With the exception of the Netherlands and Portugal, disclosures made by investors under the current short selling restrictions across Europe will be made public. Most regulators require disclosable short positions to be calculated daily and reported on the business day following the day on which the investor reached the threshold for disclosure.

Initially some regulators (e.g. UK) required that a disclosable short position be reported on every day that it was held, however this requirement has now been relaxed.

We do not have sufficient evidence to assess whether or not the disclosure requirements achieved their intended objectives or to what extent it had an effect on the actual compliance costs for the industry, simply because the prohibitions against short selling resulted in a very limited number of disclosures. That said, if disclosure requirements were to be considered without simultaneous prohibition against short selling, the same concerns about a common understanding on key definitions as discussed above would apply. Consequently, EU wide disclosure requirements should not be introduced before there is a common understanding on how to construe key concepts. There are a variety of aspects to be considered, some major aspects are mentioned below to allow for a meaningful discussion.

Disclosure requirements should apply to the end user; this was generally applied consistently (with the exception of Portugal where brokers were required to report trades). There should also be consistency, in the case of investment managers and funds, as to whether disclosure is required at the individual fund level or aggregated at the investment manager level. We suggest that any such regime should exclude the client serving activities of regulated intermediaries and market makers so as to avoid exacerbating the risks that such institutions face in their provision of liquidity to the market. Additionally, consideration should be given to other required exemptions, such as those for underwriting and sub-underwriting groups with respect to such roles in the capital raising process.

There should be no arbitrary differentiation among various industries or sectors. A disclosure regime should apply for all shares of a certain market or jurisdiction.

Any disclosure requirements have to be linked to short selling – subject to a clear definition of “short selling”. It should be made clear, whether it is linked to physical or additionally to synthetic positions.

In each case, it should not be linked to any form of stock lending. Covered short selling is always linked to stock lending, but the reverse is not true. Stock lending is not an appropriate indicator for short selling. Stock lending fulfils a lot of other objectives with respect to the functioning of efficient financial markets. Among others, it is used as a substitute for collaterals, it helps to avoid frictions in the settlement of securities, it enables investors to achieve control on voting rights for a limited time span, and it forms the prerequisite for various dividend strategies. In addition, due to the constant trading among various market participants, it might be difficult to define, who the “end lenders” of a certain stock lending position would be. Therefore, a lot of duplicate information could occur. In addition, according to the Transparency Directive the notification of major holdings doesn’t apply to shares acquired for the sole purpose of clearing and settlement (art. 9 (4) of the Directive).

Any disclosure should be communicated by the individual investors to the regulators, aggregated by them and regularly published on an anonymous basis. However, such disclosure regulations correspond to the disclosure regime implemented by the Transparency Directive only at the very first glance. There are fundamental differences. The disclosure rules of the Transparency Directive refer to long positions only. In those cases, the buyers of the shares normally have an interest in achieving some kind of control on the company. Therefore, their identity should be known to the company, the other investors and public. Short selling is different to “long purchase” by nature: it cannot be linked to an intended control on a company, but only to making profit subject to falling prices. It is not relevant for the market, who the short seller is, but what amount of shares is subject to short selling.

Even for short sellers it is important to know, what amount of short selling in a certain stock has already been done. Due to the rapidness of potential market developments disclo-

sure should be made and published on a daily basis. Such disclosure would also provide relevant information to other potential short sellers who would certainly add that information to their investment scenario before entering into a concrete transaction. However, it should be mentioned, that the Porsche Volkswagen case would have been avoided, if Porsche had been subject to a disclosure with regard to synthetic long positions (equity swaps).

In addition, a threshold level has to be defined. On this, ESME would not submit a recommendation for a fixed certain number, for example 0.1 per cent, 0.5 per cent or 1.0 per cent prior to additional intensive research, but would not support a flagging of orders in order to implement the disclosure rules. There is agreement that the threshold levels should be significantly lower than those fixed in the Transparency Directive for long positions in stocks. Aspects to be taken into consideration should include the free float in a certain stock, the daily turnover, the market capitalization as well as the question whether the threshold should be applicable on a gross or a net position. However, ESME recommends that the regulators should publish not only the total amount of short selling in a certain stock, but also at least the number of registrations and potentially other categorisations, to allow the markets to take a more differentiated view on the short selling in a certain stock. It makes a big difference, whether there is 5.0 per cent short selling done by one investor or by 10 investors.

In addition it could be discussed whether a specific disclosure requirement should be implemented with regard to rights issues already implemented by the FSA based on its statement, already quoted above, that "companies undertaking rights issues are more vulnerable than the generality of securities to short selling"[44].

Market making

Most European regulators have provided for an exemption from the restrictions for market makers. However the definition of 'market maker' differs between the jurisdictions: some jurisdictions have limited the exemption to market makers registered with or recognised by a market operator (for example, the Euronext countries, which require a market maker to be a designated market maker as defined in the Euronext rule book), while others have provided definitions in varying degrees of detail.

The Irish regulator specified that (a) a person is a market maker only to the extent that they are or have been operating as a market maker ordinarily as part of their business; (b) market maker includes but is not confined to persons recognised as a market maker by a Market Operator (as defined in MiFID) when operating as such; (c) a person who operates as a market maker may also undertake other activities and those are not covered by the market maker exemption; (d) operating as a market maker means trading in good faith as principal to fulfil orders or instructions received from clients; (e) operating as a market maker may include trading in good faith to hedge positions arising from client orders or instructions; (f) no discretionary management activity or proprietary trading for the purpose of achieving trading gains falls, other than in compliance with (b) above, within the scope of market making activity.

The Italian regulator has defined 'market maker' as any person who holds himself out on regulated markets and multilateral trading facilities on a continuous basis as being willing to deal on own account by buying and selling financial instruments against his proprietary capital at prices defined by him.

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[44] See FSA, Discussion Paper p. 11.

The UK FSA also provided a detailed description of what it considers to be market making activities for the purposes of the short selling restrictions. This description is not linked to the existing definition of market maker in the FSA Handbook. A market maker is described as an entity that, ordinarily as part of their business, deals as principal in equities, options or derivatives (whether OTC or exchange-traded): (a) to fulfil orders received from clients, in response to a client's request to trade or to hedge positions arising out of those dealings; and/or (b) in a way that ordinarily has the effect or providing liquidity on a regulator basis to the market on both bid and offer sides of the market in comparable size. Trading in circumstances other than genuinely for the provision of liquidity is not exempt.

The FSA also clarified that the exemption covers market makers only when, in the particular circumstances of each transaction, they are acting in that capacity. Proprietary trading strategies where the main intention is to create a short position will not be considered to be market making activity and will not be exempt.

Regulated intermediaries and market makers play an important part in the orderly operation of the equities market. Consequently, provision should be made to exempt such parties *when operating in a client serving capacity* from the application of any short selling rules.

Representations of compliance

Most regulators imposed the restrictions directly on those making the transactions, others (like France and Spain) required intermediaries to obtain prior confirmations from their clients that they were not entering into short positions. Regulated intermediaries, absent any knowledge to the contrary, should be able to assume that counterparties are trading legitimately in accordance with regulations without the need for confirmations (whether prior, written or verbal).

Another feature that might be an issue in this regard is the impact of algorithm trading and DMA-facilities, even though we have not gathered evidence on how big a problem this might be. It is clear however, that technical and regulatory development (e.g. MiFID) as well as the enhanced competition between trading venues has facilitated computer generated trading which today counts for a substantial amount of the over all volumes in the market. Hence, it may be assumed that algorithm trading contribute to liquidity in the markets, and is a positive feature to the price formation process. By requiring actual holdings at the time of the trade (as in some jurisdictions), it may reasonably be assumed that the room for algorithm trading is restricted. Even though many members states recognize the existence of agreed upon arrangements for stock lending as equivalent to actual holdings, this may also restrict the possibility to use automatically generated trades, which is also the case where the intermediary is required to obtain confirmations by the seller prior to effecting the transaction.

Basis of the rules

The legal basis for the restrictions varied across member states; some relied on a broad interpretation of the market abuse rules, others introduced short selling restrictions without reference to other regulation and some applied already existing short selling regulation that historically had been introduced in order to guarantee timely settlement of transactions.

The variations above caused a number of practical problems to the market, because a practise that was fully legitimate in one jurisdiction could potentially be prohibited in another. This is illustrated by an example based on an actual (but most likely not uncommon) case set out below.

Firm A has entered into CFD transactions with a client B, resulting in that B holds a long position in the CFD, and A holds a short position. To hedge such short position, A also buys underlying shares in the cash market at a value of (as example) 50. At that time, the prop desk within A holds a short position in the shares at a value of 100 (which was held at the time when the short selling restrictions were introduced). Therefore, the hedge transaction reduces the short cash position from 100 to 50. After a while, B closes out its position in the CFD, and A unwinds the hedge cash position, which again increases the short cash position from 50 to 100.

The example raises two practical questions. One is that the trading within at least major global financial institutions is carried out independently by different desks with different investment strategies and objectives. While the objective of the prop desk is to generate profits in the institutions own trading book, the main objective of the hedge desk is client facilitation plus management of the risks associated with counterparty positions. Still, all trading is done by one of the same legal entity, and any investment decision within such entity would contaminate all parts of the institution. This said, the unwinding of the hedged cash position in the example would most likely be acceptable under a concept based on the net short position, since the divestment of the shares would correspond to the closing of the short position in the CFD. However, in a jurisdiction which only recognizes transactions in the cash equity market, the outcome would certainly be the opposite.

Settlement procedures

In order to provide certainty for an increasingly international investor base it would prove beneficial to achieve consistency and co-ordination with respect to buy-in rules to facilitate an efficient settlement process.

However, it should be recognized that such rules are closely connected to the design and market model of relevant infrastructure providers (such as regulated markets, multilateral trading facilities, central counterparties or even central securities depositories). Any European regulatory initiative in this field should therefore be based on high level principles, to leave the details to be designed locally (or at the particular market level). The point could also be made that buy-in rules would normally apply in circumstances where a delivery has already failed, whereas the mean to mitigate the risk of a failed delivery in advance would normally be dealt with through (manual or automatic) stock lending facilities.

5. Lessons to be learned: suggestions for future regulations on short selling

- *We have not found evidence that market abuse should be considered as a specific element with respect to short selling.*
- *Short selling prohibitions should only be applied in extreme circumstances as a short term response to a specific event, they should not be applied as a matter of course or as regular feature of equities markets.*
- *Any potential future regulatory measures should be considered on a 'cost-benefit' basis. Care should be taken to ensure that the application of any measures do not disadvantage markets or market participants from a competitive standpoint.*

In general, there appears the need for a global approach and close coordination among global, European, and regional regulators, respectively. It should be discussed whether a European Crisis Management Forum among regulators and supervisory authorities should be established. Any future common standard for regulations on short selling should not simply adopt the regime with the strictest standards already in place ("levelling up"), but should implement rules which are reasonable with regard to market efficiency and market protection. No regulation by a single Member State should be implemented before a common position among the EU institutions has been reached.

The scope of most present restrictions referred to financial stocks in the equity market. In this regard ESME has neither analyzed whether short selling in the bond markets could have any comparable negative effects nor submits any suggestions for rules and regulations to be imposed on the bond markets. On the one hand, prices and yields on the bond markets express the creditworthiness of a certain issuer, so that any short selling could dampen the view on the creditworthiness by the market. This could become public and affect also the price of the share of that company in the stock market. On the other hand, bond markets are dominated by institutional investors and are subject in principal to limited public interest, while developments in the equity markets could affect all financial markets and are therefore subject to the utmost public interest, as the recent turmoil has shown.

We have not found evidence that short selling could contribute or lead to pressure on stocks in a specific manner not possible via long positions. However, short selling can be used abusively (particularly where naked short selling occurs), and can contribute to disorderly markets. These types of risks are considered insufficient to warrant a ban on short selling. The potential for providing access for market abuse is an element that applies equally to long purchases and therefore should not be considered unique to short selling alone. However, it has to be agreed, that the potential for short selling is greater for naked short selling than for covered short selling.

Overall, recent empirical studies have shown that prohibitions against short selling result in adverse consequences in terms of liquidity. Such prohibitions might on a short term basis serve as a cushion against sudden drops in share prices, and should therefore only apply as a last resort in case of financial markets crises. However, there are other means of achieving the same results, which should be exploited before prohibitions against short selling are considered. Therefore, short selling prohibitions should only be applied in extreme circumstances

as a short term response to a specific event, they should not be applied as a matter of course or as regular feature of equities markets.

Regulators should have the ability to impose such measures in extreme market circumstances without the requirement for lengthy pre-consultation. However, the impact of such measures should be fully and carefully considered with respect to their market impact and appropriateness to the specific situation prior to their implementation. Further, there should be proof of due process having been followed to ensure that the significant disruption to the market has been adequately considered, such that market participants have confidence in the steps taken.

In each case, ESME suggests that regulators agree on a step by step approach when implementing restrictions on short selling. Such steps could be:

i) Restrictions on naked short selling

ii) Implementation of circuit breakers

iii) Restrictions on covered short selling

iv) Restrictions on instruments allowing for investing in falling markets

Suggestions for future regulation

Any potential future regulatory measures should be considered on a ‘cost-benefit’ basis and allow for pre-consultation with interested parties. Care should be taken to ensure that the application of any measures do not disadvantage markets or market participants from a competitive standpoint.

Disclosure rules

This could be achieved in various ways, but we suggest focusing on rules on an aggregated and anonymous basis that may provide useful information to both regulators and other market participants. As set out under the above section, such measures should be applied on a consistent basis across jurisdictions to avoid limiting usefulness and increasing costs.

As the implementation of disclosure rules is very onerous if it is done on very short notice, it should be discussed, whether it should be implemented as a permanent measure for increasing transparency on markets. However, due to the complexity of disclosure rules further research is needed on a regime which is appropriate for the regulators as well as for the market participants.

The EU common position should take into account the following topics. Once agreed on the necessity of disclosure it should be established:

i) A single and unambiguous definition of short selling (and naked short selling);

ii) The sectors subject to the disclosure: only to securities of financial sector or all the securities admitted to trading on a regulated market;

iii) The application only to shares or also to other securities (such as derivatives);

iv) The threshold for any disclosure requirements;

v) The channel whom disclosure must be given (only the Competent Authority or the market);

vi) The person responsible for the disclosure (the intermediary or the holder, as set forth for the notification of major holdings according to the Transparency Directive);

vii) The frequency of the reporting requirements.

Settlement procedures

Consideration should be given to the application of buy-in rules. Such measures could make markets operate more efficiently and address potential settlement impact of naked short selling. For example, such rules operate in Italy.

Circuit breakers

Circuit breakers restrict short selling if the market falls by a certain percentage. Such measures are not practical for a number of reasons:

i) multiple execution venues – to which would the circuit breaker be applied?

ii) application to derivatives or solely stock?

iii) cost of implementing such systems

iv) participants understanding of such measures, and

v) questionable effectiveness of such measures – may further destabilise the market.

Given the number of practical drawbacks in a multi-execution environment, this is not considered as a viable proposal. Setting aside the significant costs to implement such measures, circuit breakers suffer as they are extremely difficult to implement (e.g. algorithmic or DMA trading) and further have not proven effective in their application.

Uptick rules

With respect to the uptick rules, it is worth examining the US experience. In 2004 an SEC study found no evidence that the uptick rules helped to support the market. Further, it was found that the rules "..modestly reduced liquidity and do not appear necessary to prevent manipulation..". The SEC after due consideration of the impact of removing the rules and after careful evaluation of the evidence, decided that such a move was in the interest of the market.