

October 2010

Short Selling

Executive summary

On 15th September 2010 the European Commission published a regulation proposal designed to create a harmonised framework for the short selling of securities across Europe. The regulations aim to manage certain perceived risks¹, namely:

- transparency deficiencies;
- negative price spirals; and
- settlement failures associated with naked short selling.

The proposals would give authorities the power to restrict or ban short selling temporarily in “emergency situations”; increase transparency to regulators and the market about short selling positions; and reduce settlement risks of uncovered or naked short selling. A number of other provisions proposed go beyond the recommendations made by CESR², including the flagging of short sale trades, the establishment of mandatory buy-in arrangements, and requirements to reserve securities before selling short (as opposed to a locate requirement).

Although, supportive of the move to establish a harmonised framework for short selling we strongly believe that some of the specific proposals are disproportionate to the actual risks being addressed and will have negative consequences for the financial markets and its users.

Overview and Background

There are several variations of short selling but the core principle is that one market participant agrees to sell an asset that he does not own at the time of sale. This security is borrowed from a third party. The borrower will look to buy an identical asset at a later date in order to return the borrowed shares.

Short selling is a well-established investment activity, essential for market making and widely accepted by investors and regulators (e.g. IOSCO and CESR) as helping to enhance

¹ Proposal for a Regulation on Short Selling and Credit Default Swaps - Frequently asked questions (EC September 2010)

² CESR 10/088

price discovery, counteract supply/demand imbalances, hedge other positions/exposures and provide liquidity to the market in the relevant securities.

Without short selling there would be significantly less liquidity in the markets. It enables financial institutions to purchase specific securities at the time and price of their client's choosing by taking on the risk of loss themselves. They can then cover the sale to the client at a later time.

Some of the recent proposals and announcements on short selling seem to be based on the misconception that it causes market volatility and is a speculative activity which should be diminished. In fact, studies have shown that banning short selling has resulted in reduced liquidity, increased volatility, wider bid/ask spreads and less efficient price formation³.

Both the FSA and CESR consultation processes on short sales did not establish that they are more susceptible to misuse than purchases or other types of sales. There is no strong evidence to suggest that short selling was behind the price falls during the crisis of spring 2010. In fact, most of the adverse market movements can be attributed to fundamental factors⁴. In general, short selling is a symptom not a cause of the problem.

Any regulatory interventions regarding short selling must be careful not to harm the overwhelmingly positive contribution that short selling makes to the financial markets.

Summary of the AFME and ISLA position

AFME and ISLA support the move by the European Commission to develop a harmonised regulatory framework for short selling across Europe. However, the proposed regulation is not proportionate to the actual risks that short selling poses. The costs of complying with the regulations and the negative effects to financial markets will be great. The following is a summary of our position with regards to the key proposals in the regulations:

- **Private disclosure to regulators of short positions.** We support the proposals for private disclosure of net short positions in shares to enable regulators to effectively monitor market activity. On the reporting of net short positions in Credit Default Swaps (CDS), it is important to take into account their role in proxy hedges. CDS that hedge an economic interest of the bank should not be considered uncovered.
- **Publication of short positions in stocks.** Analysis published earlier this year⁵ shows that existing public short selling disclosure requirements reduce equity market liquidity by at least 25% and cause bid/ask spreads to widen significantly. So whilst we are not against measures designed to increase public transparency in financial markets, we recommend a sensible calibration of the threshold for

³ See Beber and Pagano 2009 and Boehmer, Jones and Zhang (2009)

⁴ IMF staff comments on EU Commission consultation on short selling (2010)

⁵ The effects of public short-selling disclosure regimes on equities markets (Oliver Wyman 2010)

publication and propose one of 3% to match the lowest threshold for reporting of long positions.

- **Limitations on uncovered short selling.** The requirement to have located *and reserved* a security before the short sale is disproportionate and too restrictive. Even with the exemption for market makers, the ban will reduce the number of liquidity providers in the market and thereby reduce liquidity. This means higher borrowing costs for governments and companies. Furthermore, in line with several national legislative efforts, day trading activity should be excluded from the restrictions.
- **Marking short orders of shares on trading venues.** This requirement would incur disproportionate implementation costs. Additionally, the information provided to the market will be confusing and not particularly useful.
- **Mandatory buy-in procedure in cases of a failed trade.** We have a number of concerns about this proposal. First of all, trades can fail for many reasons not associated with short selling. This argues against inclusion of the proposal under short selling legislation. Secondly, temporarily disallowing short selling by parties who may have unintentionally failed to settle by settlement date is disproportionate to the actual risk that failed trades pose and will prove hard to enforce. Thirdly, the regulation would be very difficult, if not impossible, for trading venues to enforce as they would not be capable of handling the implementation burden that would be placed on them to determine losses/profits of parties where there is a settlement failure, nor to adjudicate penalties based on them. This may lead to less competition in these markets and could even drive business from regulated execution mechanisms to an unregulated execution mechanism.

While recognising that sovereign states need powers to operate in emergency circumstances, it is important to note that historically **emergency bans on short selling have actually increased volatility⁶ and pose a real danger of increasing systemic risks.**

AFME's Response to the CESR and EU consultations on short selling can be found on <http://www.afme.eu/document.aspx?id=4180>

Further information

- ISLA paper on short selling and securities lending, July 2009: [http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SECURITIES%20LENDING%20AND%20SHORT%20SELLING%20\(3\)%20\(3\).pdf](http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SECURITIES%20LENDING%20AND%20SHORT%20SELLING%20(3)%20(3).pdf)
- ICMA white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure, July 2010:

⁶ IMF staff comments on EU Commission consultation on short selling (2010)

<http://www.icmagroup.org/ICMAGroup/files/ac/ac9739eb-6c8b-4d0f-9f5c-d0f13e89bd8e.pdf>

- Oliver Wyman report “The effects of short-selling public disclosure regimes on equity markets”:
[http://www.managedfunds.org/downloads/Oliver Wyman Financial Services Report.pdf](http://www.managedfunds.org/downloads/Oliver_Wyman_Financial_Services_Report.pdf)
- IMF Staff Comments on EU Commission Consultation on short selling:
<http://www.imf.org/external/np/eur/2010/pdf/080510.pdf>

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