



Short Selling

A comprehensive review of regulatory proposals

December 2010

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1. 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 Committee of European Securities Regulators (CESR)², 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).

Overview and Background

There are several variations of short selling but the core principle is that a 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, such as the International Organization of Securities Regulators (IOSCO) and CESR, as helping to enhance 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.

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

² CESR 10/088

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 that 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.

Neither the Financial Services Authority (FSA) nor CESR consultation process on short sales established 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, ISLA and ISDA position

AFME, ISLA and ISDA 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 on 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 per cent and cause bid/ask spreads to widen significantly. So while we are not against measures designed to increase public transparency in financial markets, we recommend the publication of aggregate anonymous data for short selling or as an alternative, an increase in the threshold for public disclosure to 3 per cent 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. Therefore, we recommend the removal of the

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)

reservation requirement from the article. Furthermore, while we fully endorse a locate requirement for equities markets, we believe such a requirement for government bonds is both unnecessary and burdensome. Finally, 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 are concerned about this proposal. While some fails are due to uncovered short selling, there are multiple other causes, including differences in the operating schedules of securities settlement systems and the non-delivery of the securities to the seller. Given the range of other possible reasons for fails, it is inappropriate to seek to address these in an legislative instrument limited to short selling. EU legislative efforts to improve settlement discipline should instead be contained in specific legislation on securities settlement. If buy-in provisions are nevertheless retained in the Regulation, changes are needed to improve their workability and minimise damage to liquidity. Recommended improvements include: referencing of buy-in procedures to settlement day rather than trade day given current differences in settlement cycles (e.g. trade day plus two or three days); and setting the buy-in date eight business days after the settlement day to give failing counterparties (not least those located in non-EU time zones) sufficient time to address the fail.

The market maker exemption is an important part of the legislative proposal. Legislators should cooperate closely with the industry to ensure the exemption is well defined and the notification procedure is proportionate.

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

2. Short Selling: Social Benefits

When equity and bond prices are falling commentators often criticise short selling, claiming that it leads to disorderly markets and exacerbates price falls. These concerns have led to much research⁶ into the real effects of short selling on the capital markets, which has found that allowing short selling:

- means prices adjust more quickly to new information about fundamentals;
- decreases the likelihood of price bubbles;
- leaves unchanged or even reduces the probability of price crashes;
- leads to lower trading costs, higher turnover and improved market liquidity; and
- may lead to higher equilibrium prices as investors have greater confidence that prices are fair and therefore require lower returns to compensate them for risk.

In its 2009 paper on short selling⁷, IOSCO stated: “short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities.”

Why does this matter?

Improved liquidity, lower dealing costs, better price formation and better risk management are important not just to professional investors and investment banks, but to all users of the capital markets, including Government and corporate issuers of securities, long term investors such as pension funds, and retail investors.

Corporate issuers of securities, who use the markets as an effective way of raising capital to finance their businesses, are able to **raise capital on cheaper terms** than they would do in a less efficient marketplace. This can be seen in markets where short selling is restricted, such as many in the Middle East. A good example recently involved the Dubai listed Emaar Properties. Their US\$500m of convertible bonds had incurred costs of an estimated US\$50m over a five year period because of the high coupon (7.5%) the company had to pay to investors who were unable to hedge the convertible bond position by selling the equity short. **Put simply, because short selling was not available to investors, this company had to pay substantially more to raise finance than a comparable company issuing a similar bond in a market that did recognise short-selling.** This money could have been used for developing new businesses, supporting economic growth and increasing employment.

⁶ See [Securities Lending and Short Selling, ISLA July 2009](#)

⁷ See [Initiatives Relating to Restrictions on Short Sales, IOSCO October 2008](#)

Similarly, a **sovereign issuer** needs to be able to rely on its primary dealers' ability to use uncovered short-selling to place its sovereign debt with investors. A primary dealer that receives an order to buy sovereign debt from the state has, by definition, to go short since the bonds have not yet been issued. Without short-selling the cost to the sovereign of funding itself would increase - with direct implications for citizens of that state.

Without short-selling, **long term investors** such as pension funds, asset managers, insurance companies and individual savers, who look to use the financial markets as a way of generating returns to pay for their pensions and other necessities, would be **exposed to greater volatility, cost and risk from their investments, alongside decreased choice, performance and return**. Short selling is also a key driver for the borrowing of securities. Long term investors generate important returns from lending their securities and reductions in short selling activity would threaten this.

A further valuable benefit that short selling bring to society concerns its role in helping to prevent price bubbles, which can ultimately lead to crashes and economic downturns. Short sellers are able to express well researched and sceptical views in the market that help to correctly price securities. In markets where short selling is constrained, these views will not be expressed and this raises the risk of asset prices becoming over-blown. Short selling has sometimes been criticised for the demise of companies such as Enron, Lehman, HBOS and Northern Rock. But with the benefit of hindsight it has been shown that short sellers were not the cause of the demise, the real reason being the mismanagement and poor fundamental state of these institutions. Both long investors and short sellers who sold their shares were simply expressing their well researched views that these firms were overvalued and destined for problems.

Directional short selling, hedging and market prices

Many guides to short selling describe the process as an investor selling a security today in the hope that the price will fall and the security can be purchased at a lower price in the future. This describes an investor making what is called a directional investment decision. The majority of short selling however is used to hedge other positions, meaning that the short seller is doing so to help manage another investment risk. In these situations the short seller may not be betting on a fall in the price of the security, and is concerned only with how the price moves relative to another investment. Without short selling it becomes more difficult to hedge these investment risks. An eminent US fund manager⁸ estimated recently that 95 per cent of all short interest in the US equity market was related to hedging.

In a recent speech, Professor McKenzie of the University of Sydney⁹ showed that spikes in short selling activity in the Hong Kong equity market were as likely to be followed by market price rises as they were with falls. This is partly explained by the fact that short

⁸ Jim Chanos. The Power of Negative Thinking, CFA Institute Conference 2010

⁹ [The Role of Short Selling in Equity Markets, Professor Mckenzie](#) University of Sydney

selling is used not just for directional investment strategies but also for hedging. It should also be noted that a short sale can only happen if there is another party willing to buy the securities. It cannot just happen by itself.

The challenge of regulating short selling

Following the emergency bans imposed during the height of the financial crisis, regulators around the world have sought to introduce rules to help control short selling activity. The challenge they face is to develop rules that provide them with confidence that short selling will not somehow damage the market, without reducing the valuable role that short selling is shown to actually play. There is growing understanding about these benefits and therefore the need to avoid outright bans. Some of the measures being discussed, such as certain controls on uncovered short selling, requiring public disclosure of short positions, and imposing blanket buy in procedures, may simply serve to reduce the beneficial effects of short selling, damage the market and ultimately affect the wider economy.

There are two principal areas that we believe would benefit from regulatory focus. The first concerns the need to ensure that uncovered short selling (where an investor sells short but doesn't make adequate provision to borrow securities or otherwise cover the sale in a timely fashion) doesn't lead to unacceptable incidents of unsettled trades. There is actually no evidence that this risk is real or apparent in the European markets but nevertheless a proportionate and sensible regulatory approach may be desirable. The other concerns the requirement for regulators to have sight of material short positions taken by investors. Short selling is no more susceptible to market manipulation than the buying or selling of long positions, but market participants generally accept that if regulators have sight of material short selling positions it should help to allay any concerns that this activity is somehow problematic.

3. Equity Short Selling and Public Transparency

The European Commission's draft 'Regulation on Short Selling' proposes measures designed to enhance transparency of significant short positions in specific financial instruments. For equities it proposes a two-tier model with private disclosure to regulators of short positions that exceed 0.2 per cent of the issued share capital of any European company, and disclosure to the public of short positions that exceed 0.5 per cent. The stated policy objective of the public disclosure requirement is "to provide useful information to other market participants about significant individual short selling positions in shares."

The word 'transparency' is one that mostly has positive connotations. However, we believe that disclosing short positions to the market will in fact have a number of damaging consequences. Because of this we support:

- full disclosure to regulators; and
- aggregated, anonymous disclosure to the public / market.

How can public disclosure be a bad thing?

A research study by Oliver Wyman¹⁰ in 2010 examined the effects that short selling public disclosure requirements had on a sample of financial shares against a control sample of similar shares that had no such disclosure requirements. It concluded that "regimes imposing manager-level short selling public disclosure have materially negative impacts on their markets." The report also identified that "These primary impacts affect all investors equally. If markets become more expensive and difficult to trade, all investors – retail, institutional and hedge fund – will be impacted by these changes."

The findings are revealing. The shares with the short selling disclosure requirement were shown to have:

- **Materially reduced liquidity and lower trading volumes.** This simply means that there were fewer investors and market participants willing to trade. So the opportunities to buy and sell were reduced when compared with the control sample shares. Liquidity is perhaps the most important consideration for investors that are considering buying shares in the primary markets and companies looking to raise capital will generally need to price their issues lower to attract investors.
- **Significantly wider bid-ask spreads.** This is mainly a result of the reduced liquidity in the market, which leads market makers and other liquidity providers to charge clients more to buy and sell the shares. They do this to compensate themselves for the additional costs of hedging their risk. Investors buying or selling

¹⁰ See [The effects of public disclosure regimes on short selling markets](#)

these shares end up paying more or receiving less than they would for a comparable share that isn't subject to short selling public disclosure.

- **A higher probability that prices do not represent “fair value”.** A vast body of academic research shows that short selling enhances the price formation process, meaning that the price of shares in the market is more likely to be reflective of the fair value of the company in question. When shares are not priced at fair value, someone (such as a pension fund or retail investor) is paying too much or receiving too little when they buy and sell.

How does public disclosure create these negative effects?

The simple reason is that many short sellers deliberately stop selling to avoid breaching the public disclosure threshold. This artificially limits the amount of short selling that takes place and in turn reduces the positive societal effects of short selling noted in section two of this paper.

The main reasons that short sellers do not want to publicly disclose their positions is that they do not want others to simply copy their investment strategies. Disclosure would place short sellers in an unfair position relative to long position investors who are not required to disclose at such low thresholds.

Where firms adopt short selling investment strategies, they will often invest heavily in advance research to make effective and robust determinations about the prevailing price of the security in question. For example, they might consider that it is overpriced relative to similar securities in that sector (implying a judgement about relative value), or they might consider it to be overpriced relative to the overall value of the issuer (implying a judgement about absolute value). It is natural that they would not want to publicly disclose positions that other investors would simply copy without holding any real investment conviction. A situation where uninformed investors follow the investment strategies of short sellers without any understanding of the reasons for the position does not make for a well functioning market. This risk is often called herding.

The second reason for not breaching the public disclosure threshold is that if other market participants are aware of short sellers' significant positions it exposes them to something called a “short squeeze”. In essence this means that long investors will act to try and keep the relevant share price high in the knowledge that the short seller must ultimately buy back the shares to close out his position. Long investors are generally not required to disclose their positions until they reach much higher thresholds, and even then the risks to them are low as it cannot be assumed by other market participants that they will be sellers.

Meeting the policy objective of public short selling disclosure

The policy objective of short selling disclosure mentioned above could be met by reporting aggregated anonymous short positions. This would provide the market with useful information about the level of short interest in a particular share without exposing individual investors to unfair risks. Short sellers are supportive of the notion of private disclosure to regulators but the value of public disclosure is not clear and poses many risks. Pushing ahead with public disclosure requirements will have negative consequences for the efficiency and users of the European financial markets.

Whilst we believe strongly that aggregated and anonymous disclosures provide the best means of meeting the stated policy objectives without harming the investors and issuers that use the markets, we are mindful that there are those that feel strongly that there should be some form of public disclosure. If such disclosure is still considered desirable we believe that it should only **occur at thresholds that are much closer to those required for disclosure of long positions.**

4. Sovereign CDS

A CDS is a derivative contract in which one party pays a periodic fee to another party in return for a payment in the case that a named firm or country – the *reference entity* – defaults (typically this would mean a bond issuer defaulting on its repayment obligations). In the case of a sovereign CDS contract, the reference entity is a national government that incurs various forms of indebtedness, for example by issuing bonds. An investor is said to hold an uncovered or *naked* sovereign CDS position when they enter into a CDS contract without simultaneously holding an investment in the bonds issued by the government to which to the CDS contract refers.

This section explains how a **ban on naked sovereign CDS** would make it **more difficult for market participants to manage the credit risks** they face (including those that arise from exposures other than to bonds), **damage liquidity in government bond markets and affect the cost of borrowing**.

Sovereign CDS and sovereign debt prices

EU Member States routinely borrow money by issuing bonds and selling them to capital market investors. Naturally, investors demand a higher return (or “yield”) for bonds issued by governments more at risk of default.

Over the course of 2010, the yield on the bonds of many governments, notably Greece, rose significantly, reflecting the deteriorating fiscal situation in many European states. Some commentators, overlooking rising debt levels and current account imbalances, blamed this increase on holders of naked sovereign CDS contracts, arguing that speculative activity in the CDS market was sending a negative signal to investors in the underlying bond markets. Such sentiments typically underlie calls to ban naked sovereign CDS positions.

In fact, the European Commission’s own work on Sovereign CDS¹¹ revealed that pricing in bond markets appeared “justified”: “Government deficits, debt levels and current account deficits give a consistent picture of vulnerabilities.”

Reasons for increased CDS prices

Firstly, it is important to note that there is no evidence of widespread speculative activity in the sovereign CDS market nor of speculation driving price changes. Increasing CDS prices are largely driven by a combination of fundamental factors, accounting changes and impending capital rules introduced by Basel III, that give banks a strong incentive to ‘hedge’ credit exposures to sovereign entities arising from derivatives used by those sovereigns.

¹¹ As reported in the press in December 2010

The European Commission's review of the sovereign CDS crisis notes that "The correlation between the average level of sovereign CDS spreads in the second half of 2009 and the forecast for the budget deficit in 2010 is relatively strong." This illustrates the importance of fundamental factors in CDS pricing and does not support the idea that speculative activity drives CDS prices.

New accounting and capital rules have also played a role in increasing CDS prices. When a government borrows money by issuing bonds it may decide to 'hedge' the risk associated with the interest payments it will need to make to investors. Since tax revenues tend to rise roughly in line with short term interest rates, while bonds typically pay an amount based on longer term rates, governments often enter into a transaction to effectively transform the short term rate that they receive into the longer term rate that they must pay. The most common way to do this is a swap. The government enters into an agreement with a financial counterparty to receive a fixed interest payment in exchange for paying a variable or 'floating' one.

The value of the swap to either party depends on how interest rates change. Assume that a bank has entered into a swap with a sovereign issuer and, following a change in the interest rate, expects to receive money over the life of the swap. In calculating the value it expects to realise from the swap, the bank is required by accounting standards to take account of the cost of hedging against the sovereign's default. So a Credit Valuation Adjustment (CVA) is applied to the value of the swap reflecting the market price of protecting against the risk that the sovereign defaults on payments. If the price of this protection rises, then the CVA also changes.

Under the new Basel III rules, banks are required to hold capital reserves against changes in CVA. One way to manage this risk is to buy a CDS referencing the country with whom the bank has entered into the interest rate swap transaction. The purchased CDS protection then offsets the increase in CVA if the risk of sovereign default increases. The new Basel III rules have therefore contributed to a large increase in investors wanting to buy sovereign CDS contracts to hedge the risk associated with their derivative contracts, leading to an increase in CDS prices – as confirmed in the April 2010 IMF Financial Stability report.

Such contracts are technically uncovered or naked CDS because – although they are hedging exposure to a sovereign issuer – the financial counterparty does not necessarily own the bond itself.

The influence of CDS prices on underlying bond prices

Despite this increase in sovereign CDS prices, there is no strong evidence to suggest that sovereign CDS activity influences prices in the underlying bond markets. In August 2010, the IMF published empirical research on the relationship between bond yields and CDS markets for a number of developed countries, including Eurozone countries, finding that both were strongly linked to fundamental factors, such as the deficit and debt level, current account balance, GDP growth, and GDP per capita. In the words of the IMF, "sovereign CDS

has unlikely exerted a significant influence on government bond markets, for Greece or other sovereigns.” These findings were also confirmed by the European Commission in its Report on Sovereign CDS: “The CDS spreads for the more troubled countries seem to be low relative to the corresponding bond yield spreads, which implies that CDS spreads can hardly be considered to cause high bond yields for these countries.”

Indeed, the sovereign CDS market may actually serve to moderate downward pressure on troubled countries: without a liquid sovereign CDS market those hedging risks related to government bonds would instead move to short or sell any bonds or other country-related assets, putting additional and more substantial pressure on the country and its economy.

The size of the sovereign CDS market

Furthermore, the size of sovereign CDS markets is very small in comparison with the underlying bond markets, so it is perhaps unsurprising that sovereign CDS markets do not guide the yield on government bonds. Data collected from the DTCC and Bank for International Settlements illustrates this point – the net value of open sovereign CDS positions (this netting reflects the fact that many CDS positions offset each other economically) represents just a tiny fraction of the total value of government bonds in issue:

Ratio of Net CDS to Gross External Debt (General Government) Amounts in billions (as of September 2010).			
Sovereign	Net CDS	Gov't Debt	CDS/Debt (%)
Italy	\$26.1	\$2,119.2	1.2
Spain	\$15.0	\$709.7	2.1
Germany	\$15.3	\$1,740.0	0.9
Greece	\$7.1	\$374.9	1.9
France	\$12	\$1677.8	0.7
Portugal	\$8.0	\$149.7	5.3
United Kingdom	\$9.8	\$1270.6	0.8
Austria	\$8.3	\$216.9	3.8
Ireland	\$4.7	\$179.4	2.6

Sources: DTCC and the Bank for International Settlements

Sovereign CDS as a risk management tool

Some argue that naked sovereign CDS positions are illegitimate because they are insuring something that the investor does not own. This reasoning does not take account of the fact

that CDS provide an important risk management tool for a broad range of market participants:

- **International banks** that extend credit to corporations and banks located in a particular country may use sovereign CDS to hedge credit or counterparty exposures, or to provide country-level risk diversification.
- **Investors in the debt or equity of companies** in a specific country may use sovereign CDS as a "proxy hedge" against potential systemic shocks that would reduce the value of their positions.
- **Investors with large real estate or other corporate holdings** in a country may similarly use sovereign CDS.
- **Portfolio managers** may use sovereign CDS to hedge against country, liquidity and market risk related to a portfolio comprising debt or equity positions, and to better diversify their portfolios.
- **Large banks**, which typically do not require highly-rated sovereign entities to post collateral for swap arrangements, may use sovereign CDS to hedge against the risk posed by these uncollateralised exposures. As mentioned, Basel III rules encourage banks to use sovereign CDS as a hedge for swap transactions that they enter into with sovereign issuers.
- **Banking supervisors and central banks** use the price signals provided by the CDS market to assess default risks in the financial system.

Risks associated with banning naked sovereign CDS positions

Banning naked sovereign CDS positions would make it more difficult for market participants to manage the risks they face. It would also have implications for the primary market. For example, the core group of investors who purchase government bonds when they are first issued might pre-emptively enter into a naked sovereign CDS to ensure that their ultimate exposure to the bonds is within their risk appetite (the auction process involved in issuing bonds for the first time means that it is difficult to predict with certainty how many bonds they will receive). A ban on naked sovereign CDS positions would make it more difficult for them to manage that risk and potentially discourage them from purchasing newly issued bonds – leading to less liquidity in the primary market, and higher borrowing costs for governments.

As the European Commission noted, **the existence of a liquid sovereign CDS market “could be considered to be beneficial for the cost of funding sovereign deficits,** because the insurance provided allows institutional investors to take on more debt, and thus keep the yields for troubled countries lower than otherwise would be possible. From this perspective, **the CDS market seems to facilitate risk sharing.”**

Furthermore, as explained by the IMF, banning naked sovereign CDS positions would also prove ineffective. Given that the underlying need to hedge risk would remain, an outright ban would merely prompt investors to move their positions into other assets correlated

with sovereign risk, into new (potentially less transparent) instruments, or into offshore jurisdictions.

5. Uncovered Short Selling

Article 12 of the proposed regulation requires financial market participants to have 'located *and reserved*' a security before a short sale. This regulation is disproportionate and too restrictive, given the robust existing market practice. Even with the exemption for market makers it will reduce the number of liquidity providers in the market and thereby liquidity, leading to **higher transaction cost for investors and increased borrowing costs for governments and companies**. The legislation disproportionately hurts smaller companies and sovereigns and puts Europe in a disadvantageous position versus Asia and the US. Therefore we recommend the removal of the reservation requirement from the article. Furthermore, in line with several national legislative efforts (e.g. Germany), day trading activity should be excluded from the restrictions. Finally, while for equities markets we fully endorse a locate requirement, we believe such a requirement for government bonds is both unnecessary and burdensome.

The effects of article 12 on liquidity

Article 12 would oblige anyone intending to engage in a short sale to have *both* "located and reserved" the asset in advance. In effect this appears to amount to a ban on uncovered or naked short selling. Although the draft Regulation does not define "reservation" we understand it to mean that the securities in question would have to be formally put aside and effectively withdrawn from the market pending the completion of the transaction. This would have several important consequences.

Firstly, a broker would in all likelihood demand a fee for reserving securities, to reflect the fact that whilst set aside in this way they were no longer available for other uses. These higher transaction costs would reduce the number of transactions in the market, thereby decreasing liquidity.

Secondly, apart from these direct costs, there are also indirect consequences for the liquidity of the security. For example, it is common practice for investors to approach several competing parties in search of the best price to execute a transaction. If three parties are asked for a price then only one party would ultimately be asked to execute the transaction. **If a "reservation" requirement exists all three parties would have to reserve the security regardless of whether they will be awarded the trade.**¹²

In this example, three sets of securities would be taken out of the markets for the execution of a single transaction. The reservation requirement would therefore artificially distort the amount of securities that are *really* available in the markets, giving an incorrect picture of the true liquidity in the markets. This could lead to transactions not being executed, based on a false perception that there is a shortage of a given security.

¹² To put this issue in perspective, consider that typically only 5 % of 'locates' in the equities markets lead to a transaction. (This number is based on internal calculations by Goldman Sachs.)

Taking this one step further, **market participants could abuse this false picture of liquidity, and manipulate the market by artificially creating an increase in demand for a security.** Both of these scenarios would hurt market makers and other market participants, while the former are meant to be explicitly excluded from the regulation.

Market makers are not the only liquidity providers in the markets. The many different participants (e.g. pension funds, asset managers, insurance companies) all engage in (short) sales or buying transactions on a frequent basis. When they are hindered in engaging in those activities (because the costs for these transactions increase or the availability of the securities for borrowing is distorted) the amount of transactions in the markets decreases. The ensuing decrease in liquidity hurts all market participants.

This hurts the pension fund, which is faced with higher transaction costs. It disproportionately hurts small trading firms above bigger trading firms, since the former don't have the degree of access to stock borrowing that the latter have. It is also disproportionately more adverse for smaller EU sovereign bond markets, given that those markets are already less liquid.

Finally, it puts Europe at a disadvantage versus Asia and the US, where less stringent regimes apply. Transactions move to regions where transaction costs are lowest.

In the specific case of the reserving requirement, market makers, while exempted from this requirement, use the same repo (securities borrowing) markets as non-market makers. If the liquidity levels in these markets are distorted then this directly affects the ability of market makers to engage in transactions. Therefore, the decreasing liquidity in the markets is not confined to non-market makers, but has an overall effect on the way these markets function.

The link between liquidity and financing costs

The link between liquidity and the prices of securities is academically undisputed. Investors appreciate liquid securities. A security is said to be liquid when it can be easily converted into cash, and converted at the fair market value. They demand a premium (a higher interest rate or lower price) when a security is illiquid.

This liquidity premium can be estimated for any given security. For example, assume an investor is looking at purchasing one of two corporate bonds, each with the same coupon payments and time to maturity. Assuming one of these bonds is considered liquid, while the other is not, the investor will not be willing to pay as much for the less liquid bond. The difference in prices and yields the investor is willing to pay for each bond is called the liquidity premium.

Overall, reduced market liquidity will mean investors ask for a higher interest rate when an issuer issues a bond in order to be compensated for the perceived increase in market risk and hence the risk of an inefficient secondary market.

Our proposals for article 12

We believe that in a time of economic instability any measure that damages liquidity and raises financing costs must be avoided. With the current unprecedented issuance levels of European governments and the equally extraordinary yield increases in some European countries bonds, any further yield increase (i.e. raise in government borrowing costs) could have severe effects on the real economy. The same can be said for the financing costs of European companies, which already find themselves confronted with the effects of the economic crises on their budgets. The legislation is disproportionately more adverse for smaller companies and sovereigns. Finally, investors will be faced with higher transaction costs, which will impede the flow of capital and put Europe at a disadvantage versus Asia and the US. The current wording of article 12 can therefore impact on the real economy in terms of government spending, employment, etc.

We propose that the reserve requirement should be removed from article 12. Furthermore, in line with several national legislative efforts (e.g. Germany), day trading activity should be excluded from the restrictions, in line with existing market practice of both flexible and sound covering of short positions. These two changes would limit the negative effects of article 12 on the real economy.

While for equities markets we fully endorse a locate requirement, we believe such a requirement for government bonds is both unnecessary and burdensome. Therefore, for these assets, we propose to also remove the *locate* requirement from the article. The small number of failed trades in the government bond markets does not indicate there is a market failure that needs to be addressed by European legislation. Therefore, a locate requirement would only lead to burdensome implementation costs.

The sovereign bond markets are generally large, liquid and have a good track record of absence of abuse. Market participants are able to short sell a government bond to take advantage of a trading opportunity with a high degree of confidence of being able to cover that position by borrowing the asset when they need to do so. For example, in the UK borrowers typically borrow the bonds within 24 hours of selling¹³.

Furthermore, European governments have found market-based solutions to reduce the number of failed trades in their markets. Several sovereign issuers have facilities for the creation of synthetic or phantom bonds. These repo facilities enable – as a last resort should the need arise – market participants (through primary dealers) to borrow bonds from the issuer on a temporary basis to cover any short positions. In that context, mandatory buy-in procedures would be unnecessary. Examples of countries where these facilities operate successfully are the Netherlands, the UK, Belgium and Portugal. Furthermore, please note that a number of sovereign issuers have contractually obliged

¹³ This number is based on internal calculations by the UK Debt Management Office.

their Primary Dealers to limit the number of failed trades. This is the case in for example Portugal, Slovenia and the UK.

6. Buy-In Proposals of Short Selling Regulation: Article 13

This section outlines the role of buy-in regimes as one of the many tools for addressing settlement failures and explains how they can be caused by a variety of factors other than short selling.

On this basis, we recommend: that EU legislative efforts to improve settlement discipline be contained in specific legislation on securities settlement rather than within the confines of the buy-in rules of a short selling regulation; and that if buy-in provisions are retained in the regulation, amendments are needed to improve their workability and minimise damage to liquidity.

Role of Buy-In Regimes

A range of tools are available to trading venues, central counterparties (CCPs) and settlement systems to promote market discipline. These tools include buy-in procedures that are specifically designed to address settlement failures. Buy-in procedures are operated in different ways across different markets - not all markets have them and among those that do different rules apply, notably around when buy-ins may be triggered.

Settlement failures largely occur when the seller of a security fails to deliver it on the agreed date (settlement date). In these circumstances, an exchange (or in some cases a CCP or settlement system) may trigger a buy-in procedure, where it purchases the securities from another seller and delivers them to the buyer. Another model exists whereby the buyer may be allowed to trigger a buy-in itself, purchase the shares elsewhere and then charge the 'failed' seller for any additional costs incurred.

While some settlement failures are due to uncovered short selling, there are multiple other possible causes. For example:

- differences in the operating schedules of settlement systems may cause delays in the cross-border transfer and thus delivery of securities for settlement;
- the buyer may have insufficient funds on the intended settlement day or may have failed to enter receive against payment instructions; or
- another counterparty to the seller may have failed to deliver the securities to the seller in advance of the intended settlement day.

Need for Tailored Legislative Action

Given the range of possible reasons for failures we believe it would be more appropriate to develop a tailored legislative proposal capable of addressing all of the issues around settlement and covering all traded securities.

The different practices around buy-ins are a source of material risk and inefficiency, a significant barrier to a single European securities market and need to be addressed. We believe that the upcoming EC proposals to harmonise settlement cycles would be a more appropriate instrument to address these issues than the draft Regulation on short selling.

Alternative Proposal for Article 13

If European legislators ultimately decide to regulate buy-in procedures through the short selling Regulation, we advocate the following amendments to improve the workability of the provisions and limit their damage to market confidence and liquidity:

- Referring to the Article 13(1)(a) requirement that buy-in procedures be automatically triggered if the traded shares or sovereign debt instruments are not delivered on trade date plus four or six (for market makers) trading days, we recommend that the initiation of buy-in procedures be referenced to the Intended Settlement Day (ISD) and not the trade date, on the basis that ISD conventions (currently) vary between markets (e.g. T+2 or T+3). (Though we note that this point highlights that it makes sense to harmonise settlement cycles and buy-in regimes through the same initiative.)
- To give all failing counterparties (not least those located in non-EU time zones) sufficient notification to source securities and mitigate the buy-in prior to execution, we recommend that the provisions incorporate a buy-in 'notification date' (i.e. the date at which the executing party notifies the defaulting party of the intended buy-in date) three business days after the ISD (ISD+3). We propose that the 'buy-in date' (i.e. the date at which the executing party endeavours to buy the non-delivered securities in the market) should be eight business days after the ISD (ISD+8).
- The buy-in transactions should be priced as per the prevailing market conditions at the buy-in execution date in accordance with the rules of best execution, or as per the agreed price of the original transaction, whichever is higher. This would ensure that there is no profit to be made from a failed transaction.
- Referring to the Article 13(1)(b) requirements for the payment of cash compensation if the buy-in cannot be executed, we recommend the provisions incorporate a 'cash settlement date' (i.e. the date at which the executing party calculates the amount payable by the defaulting party in case the buy-in on the buy-in execution date was unsuccessful) nine business days after the ISD (ISD+9). We propose that the cash settlement amount be determined by applying: (i) the quoted offered price as at close of trading on the buy-in execution date or, if such quoted price is not available, the last traded price of the relevant security; or (ii) the agreed price of the original transaction, whichever is higher.

7. Remarks on Article 15 (the market maker exemption) of the EC proposal on short selling

Article 15/ Clause 1

Market makers do not always immediately cover or hedge a position that results from client-facing activities. For example, a market-maker may execute a client's order at a price at which there is no immediate buyer until a buyer is found at the appropriate price. The market maker must use its market and timing expertise to avoid loss and to serve the seller's best interest. Any activity by a market maker to facilitate a client's order or to provide liquidity to the market should be covered by the exemption.

It is unclear whether Systemic Internalisers (SI) are fully covered. MiFID provides a clear definition of an SI₁, but this draft legislation suggests a different definition of market making. Also, we're not convinced this covers give-up activity, which is not initiated by the client at all. This could be solved by the following additions:

- '15.1.b as part of its usual business, by fulfilling orders initiated by clients or in response to clients' requests to trade *or in preparation for [anticipation of?] a request to trade*, and by hedging positions arising out of those dealings.'
- '15.1.c as a *Systematic Internaliser*.'

We believe that Article 15(1) was slightly ambiguous and think it needs to be clarified in terms of whether membership of a trading venue exempts a firm for all their market making activities or just for their market making in relation to instruments that trade on that trading venue. We believe that the latter (narrow) interpretation would not be appropriate to the extent that trading is over-the-counter (OTC).

The wording of the market-making exemption is ambiguous, specifically sub-para (b) (client driven business and hedging). Does this exemption extend to partial hedges of client orders (e.g. a complex position that cannot be completely hedged in the market so part is taken on the prop books) and does it extend to macro-hedges?

Article 15/ Clause 3

Clause 3 exempts firms "acting as an authorised primary dealer pursuant to an agreement with an issuer of sovereign debt" - however not all countries have primary dealers and agreements have different obligations. Would the German "Bund Issuance Auction Group" be covered by this wording for example? These are not primary dealers and have no formal market-making obligations, yet they would need to short some bonds in advance of an auction.

We are wondering why clause 3 does not exempt primary dealers from articles 5, 6, and 7. As with market making, primary dealing may require the banks to go short/take protection in advance of an auction.

Article 15/ Clause 5

Clause 5 stipulates the exemption only applies if you notify the authorities 30 days in advance. However, this is unworkable if the exemption is applied on a per instrument basis (for some new bonds, the ISIN is published only shortly before issuance). Note that at present, in Germany, the exemption is applied on a per instrument level *retroactively*.

If however the exemptions are applied for a class of instruments (e.g. all government bonds of a specific issuer) this becomes more feasible. This would be our preferred solution. Also, to help facilitate the single market and decrease the burden of administration for market makers and their regulators, we propose that a firm's authorisation of a market maker in one Member State should be recognised in all other Member States.

8. Frequently Asked Questions

What is short selling?

In contrast to traditional 'long' investing, in which an investor purchases a security with the expectation of selling it at a higher price at a later date, short selling reverses that process by first selling a security with the expectation of purchasing it (covering the short sale) at a later date.

How do investors sell something they do not own?

Short sellers must borrow the shorted security to deliver it to the purchaser. The short seller returns the shares to the lender when the short is covered (i.e. repurchased). Uncovered short selling is when a security is sold short without first having borrowed, or arranged to borrow, the security in time to deliver it and settle the trade.

Who uses short selling?

A wide variety of investors use short selling but the principal ones include banks, broker dealers, market makers, primary dealers, hedge funds and traditional investment managers.

Does short selling have social value?

Short selling serves an important function in financial markets and in many investment strategies. Traditional short sellers' views of company fundamentals and prospects enhance the efficiency of the price formation process, helping to ensure that markets are liquid and reflect fundamentals. This in turn provides value to long term investors, such as pension funds and companies that raise capital in the financial markets. Less efficient markets mean that issuers pay more to raise capital and investors lose value through higher dealing costs.

When prices do not reflect fair value, society misallocates resources by investing excessively in low-return projects and insufficiently in higher-return opportunities. Interestingly, society seems to be more comfortable when prices are driven above fair value than when they are driven below fair value. It's worth noting that when asset prices are above fair value, forced buyers such as pension funds needing market exposure are paying more than they should and thereby incur increased investment risk.

Is there evidence that short sellers actually fulfil that function?

Academic research shows that markets with short selling are more efficient than those without. In addition short sellers can help to reveal where securities are over-valued, including instances of financial frauds. Their fundamental research and analysis of true

underlying value are important sources of information. Stocks with more shorting activity tend to have poor investment fundamentals, such as low cash flow, earnings and book value relative to price.

Does short selling force stock prices down to unfairly low levels?

Unfairly low prices should provide profitable investment opportunities for investors, which should prevent prices from systematically being driven below their fundamental value. Research suggests that short sellers distinguish between stocks with temporarily poor fundamentals and those with persistently poor fundamentals, indicating they influence prices fairly, on average. Moreover, much short selling is motivated by legitimate hedging activity.

9. Further information

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- IMF Staff Comments on EU Commission Consultation on short selling:
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