May 2011

Short Selling

Summary of the AFME, ISLA and ISDA position

We strongly support policy makers' efforts to establish a coordinated and harmonised pan-European framework for short selling in equities and sovereign debt markets. A well crafted regime would strengthen the resiliency, transparency and efficiency of such markets, as well as avoid the type of confusion for both industry and regulators that was experienced through unilateral actions in 2008.

We equally strongly believe that a number of unresolved issues will need particularly careful handling during the trilogue negotiations to ensure that the outcome is proportionate to the actual risks being addressed and does not unintentionally 1) raise borrowing costs for both sovereigns and corporates or 2) decrease the ability for market participants to manage their risk positions in the most effective manner.

We have identified the following issues as the main areas of concern.

- **Restrictions on uncovered sovereign CDS (the EP's article 12.1.a).** We have strong reservations about the ban on uncovered sovereign CDS transactions proposed by the European Parliament (EP). The ban will
  - decrease liquidity in both sovereign CDS and in Europe's sovereign debt markets more broadly, at a time of significant funding needs for governments;
  - increase prices for investors and corporates seeking risk protection via CDS and reduce their ability to effectively manage the risk of their exposures;
  - introduce legal uncertainty around circumstances in which it is permissible to enter into sovereign CDS contracts, thereby further harming liquidity; thus overall:
  - result in increased cost of credit protection and ultimately higher borrowing costs for sovereigns and corporates.

  We believe that the case for such an ongoing ban has not been made. The Regulation already gives both ESMA and Competent Authorities powers to prohibit or restrict sovereign CDS trading where there is a risk to financial stability or market confidence (articles 18 and 24). Moreover, Article 8 as well as the draft Regulation on OTC derivatives, central counterparties and trade repositories will ensure that authorities are provided with full disclosure in relation to CDS activity.

- **Limitations on uncovered short selling (article 12)**. The Commission requirement to have located *and reserved* a security before the short sale is disproportionate and too restrictive. The Parliament's introduction of an intra-day exemption is of some help but does not go far enough as the liquidity impact on smaller companies and smaller member states in particular could be phenomenal: with only circa 5% of located securities becoming short sales, requiring the remaining 95% to be placed in a reserve account would simply drain liquidity. It would also increase concentration among larger players since the smaller trading firms will not have the same level of access to security borrowing arrangements. Again, this would translate in higher borrowing costs for governments and companies. Therefore, we fully support the removal of the reserve requirement as in the Council compromise text which (as in the US), requires instead a 'reasonable expectation that settlement will take place when due'.

- **Disclosure of uncovered sovereign CDS position (article 4).** We believe that Article 4 should recognise that sovereign CDS contracts can be used to hedge exposures other than to debt or assets, for instance financial and foreign trade contracts. Therefore such positions should not be treated as uncovered for disclosure purposes.

- **Publication of short positions in stocks (article 7).** Analysis published earlier this year[1] 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 *anonymous* public disclosure, such as proposed in the European Parliament compromise proposal.

- **Mandatory buy-in procedure in cases of a failed trade (Article 13).** The vast majority of transactions settle on time in Europe. 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 a legislative instrument limited to short selling. We therefore agree with Parliament that EU legislative efforts to harmonise and improve settlement discipline, which we support, should instead be contained in the upcoming legislation on securities settlement.

- **Marking short orders of shares on trading venues (article 6).** This requirement would incur disproportionate implementation costs. Additionally, the information

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

provided to the market will be confusing and not particularly useful. Therefore, we support the removal of the requirement as in the Council compromise text.

- **The market maker exemption (Article 15)**. Acknowledging the important role of liquidity providers, we believe it is important that this exemption is well defined and covers all aspects of market making. We support the language of the Council compromise text.

Further information

For further reading on each of the positions outlined in this note, see the comprehensive AFME/ISLA/ISDA briefing note package on short selling of December 2010. http://www.afme.eu/document.aspx?id=4674

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