

5 August 2010

Commission public consultation on short selling

- Eurosystem reply –

The Eurosystem welcomes the intention of the Commission to propose a EU harmonised regime on short selling practices. In general, recent episodes have shown the necessity of enhancing the level of transparency in the financial markets. When considering a possible EU regime on short selling practices, it is necessary to take into account the current state of the policy debate at international level, as only coordinated actions could be truly effective in particular in crisis situations.

General considerations

In response to concerns regarding the impact of short selling in the extreme market conditions created by the financial crisis, regulatory authorities around the world adopted a series of measures regarding the short selling of equity stocks in the second half of 2008. These measures included in particular a ban of *naked* short selling in financial shares. In addition, many countries introduced rules on duty to disclose short positions that exceed a certain threshold of the company stock. Although these rules were introduced as an emergency measure to restore confidence in the markets in the context of the global financial turmoil, they have been prolonged in most jurisdictions for an indefinite period of time (e.g. in Belgium, France, Germany, Portugal and Spain) or, in some limited cases, temporarily reintroduced (Austria, Greece).¹ In addition to the prohibition of naked short selling in financial shares, national jurisdictions also introduced further reporting requirements encompassing, in most cases, disclosure obligations of 0.25% of short positions.

In light of these developments and with a view to eliminating gaps between the different regulatory approaches to naked short selling, IOSCO published a Report on regulation of short selling in June 2009 (“the IOSCO Report”) focusing on four main principles: (i) appropriate controls of short selling activities so as to reduce or minimize the potential risks that could affect the orderly and efficient functioning and

¹ On 19 May 2010 the German supervisory authority implemented a ban on (1) uncovered short sales of debt securities of euro area countries admitted on a domestic exchange to trading on the regulated market (2) the so-called “naked” credit default swaps (CDS) in which the reference liability is at least also a liability of a euro area country, i.e. the transactions in which CDS are not used to hedge default risks and (3) uncovered short-selling transactions in the shares of ten important companies from the German financial sector. The move was justified with reference to the extraordinary volatility of debt securities of countries from the euro area. Another type of ban was introduced by Austria.

stability of financial markets, (ii) reporting regime for short selling, providing timely information to the market or to market authorities, (iii) effective compliance and enforcement regime for short selling transactions and (iv) incorporation of appropriate exceptions for certain types of transactions for efficient market functioning and development.

At the EU level, CESR published in March 2010 a “Proposal for a Pan-European Short Selling Disclosure Regime” (“the CESR Report”) concerning shares admitted to trading on EEA markets. At the current juncture, several national jurisdictions are in the process of adopting the proposed CESR regime on disclosure.

The Eurosystem strongly supports the above-mentioned CESR’s initiative. Similarly, the Eurosystem considers a priority the improvement of transparency of short selling in the EU Government bond markets as further explained below.

Specific comments concerning the Commission’s questions

As regards the questions posed by the document published by the Commission for public consultation, the ECB/Eurosystem’s views are highlighted below (following the order of the Commission’s document).

Section A) Scope of financial instruments covered

(1) Which financial instruments give rise to risks of short selling and what is the evidence of those risks?

The positive role of short-selling in the market in the long run has to be acknowledged. In normal times, short-selling provides more efficient pricing, can decrease volatility, increases liquidity and improves the possibilities for hedging and risk management. Importantly, short selling also limits upward market manipulation and exaggeration (“market bubbles”).²

In the context of the current financial crisis, short selling practices on certain financial instruments triggered concerns relating to three main risks: (i) disorderly markets, (ii) market abuse, and (iii) settlement disruption.

The lack of precise data and information as regards the situation in both the cash and CDS government bond markets weakened investor confidence and further contributed to aggravating the financial crisis and to increased market volatility. In this context, *further actions could be undertaken to improve the*

² See e.g. the press release of IOSCO of 2 October 2008.

collection and circulation of information related to the functioning of the government securities markets, including the publication of data on settlement failures on government securities published in a harmonised manner.

- (i) **Risk of impairing the orderly functioning of the financial markets:** Short selling practices may facilitate re-pricing of over-valued financial instruments, contributing therefore to market liquidity and pricing efficiency. Short selling practices have also been seen as mitigating steep, temporary price increases. However, the downside to short selling is its potential to create disorder owing to the extent and speed of these “corrections”. From a financial stability perspective, the main concern is therefore that short selling practices increase the risk of disorderly markets.
- (ii) **Risk of facilitating market manipulation:** Short selling and, in particular, naked short selling, might create potential for market abuse. These market practices’ ability to accelerate downtrends, in conjunction with insider dealing, could potentially make these transactions particularly effective for the market participants whose intent is to abuse the market. As highlighted by the IOSCO report, although the definition of what constitutes manipulative activity varies across jurisdictions, behaviours designed to position prices, distort markets or mislead investors normally constitute market abuse.
- (iii) **Risk for the settlement of the trades:** In accordance with the IOSCO report, the potential difficulties in the area of settlement can arise from two main sources. First, one can refer to a situation where the short seller has not arranged borrowing ahead of the sale and feels under no strong incentive to deliver (due, in particular, to the framework of the system). Second, the changing supply and demand of financial instruments may also be a contributing factor to settlement disruption.

(2) What is your preferred option regarding the scope of instruments to which measures should be applied?
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When considering regulatory measures concerning short selling the particular features of each market segment should be taken into account. In particular as regards *the government bond markets* the following should be highlighted.

First, covered short sales do not entail obvious market manipulation risks. In the bond markets it indeed happens frequently for instance that some bonds are expensive to borrow and have therefore an added value simply because many participants borrow them to short them.

Second, in the sovereign bond markets delivery has to be made in T+1 (French BTANs), T+2 (T Bills) or T+3 for other Government bonds. Hence naked short selling has a limited “life expectancy”, otherwise a settlement default occurs, which involves to borrow bonds at punitive rates within the (I)CSD for

instance. So aggressive positions can be taken intraday or overnight, but going much beyond such a short timeframe is usually not possible without borrowing the bonds. Hence shorts over a longer time horizon are, in their vast majority, covered via the repo market. However, *a strong enforcement activity against settlement failures would be of essence.*

(3) In what circumstances should measures apply to transactions carried on outside the European Union?

The Eurosystem notes that given the integrated nature of financial markets, regulatory initiatives aimed at safeguarding the efficiency of financial markets and promoting their orderly functioning can be fully effective if taken in a coordinated way. In this spirit, the ECB has highlighted in its opinions that close coordination at the European Union level of Government measures intended to alleviate tensions in the financial markets is of crucial importance.

In this context, *the Eurosystem supports the work started by the Commission aimed at identifying the main features of an EU harmonised framework.* In addition, the proposed framework should include elements related to the cooperation with non EU countries, in particular in case of intervention to restore the orderly functioning of financial markets.

Section B) Transparency

(4) What is your preferred option in relation to the scope of financial instruments to which the transparency requirements should apply? (5) Under Option A is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?

First, the transparency regime proposed in the CESR Report for shares admitted to trading on EEA markets is strongly supported by the Eurosystem. However, the applicability of the CESR regime envisaged under option A for all types of financial instruments would require a further assessment of the suitability of the CESR regime to adapt to the specificities of the short selling underlying assets. Second, from an operational point of view, putting in place the CESR disclosure regime may prove difficult in case of financial instruments for which the primary market is situated outside the EEA or the issuer is not domiciled in the EEA, notably for enforcement reasons.

Therefore, the proposal under B in the consultation document to introduce the transparency regime proposed by CESR only to EU shares and to introduce a regime for notification to regulators of significant net short positions relating to EU sovereign bond issuers is supported³.

(6) Under Option B do you agree with the proposals for notification to regulators and the markets of significant net short positions in EU shares?

The Eurosystem agrees with the proposals, under option B, for notification to regulators and the markets of significant net short positions in EU shares and to introduce a regime for notification to regulators of significant net short positions relating to EU sovereign bond issuers.

In particular, the Eurosystem agrees with the “two-tier” system approach taken in the CESR Report, enabling regulators to benefit from prior information about the market participants’ positions which, above a certain level of significance, would be subject to public disclosure. Such an approach would allow regulators to monitor growing short positions before they are made public with a view to taking possible necessary measures to deter and constraint aggressive large-scale short selling which may threaten the maintenance of orderly markets or pose the risk of market abuse. In this respect, as highlighted by the IOSCO report, reporting requirements should not only facilitate the follow-up, by regulators, of market dynamics, and the identification of early warning signs of potentially disruptive or abusive of short sales, but also justify the triggering of on-site inspections. Such an issue would necessitate to be specifically addressed.

The benefits of the reporting requirements can potentially be supplemented by those associated with public disclosure, in particular spreading information that individual financial instruments might be overpriced. However, excessive public information can have negative market effects (e.g. reduction of market liquidity and contribution to “herding” behaviour). Therefore, it should be assessed, on the basis of a cost/benefit analysis, if a less extensive public disclosure regime where the competent authorities publish, for instance, anonymous information about short selling activities, would be a sufficient contribution to the maintenance of the smooth functioning of the financial markets.

(7) In relation to Option B do you agree with the proposals for notification to regulators of net short positions in EU sovereign debt (including through the use of CDS)? In addition to notification to regulators should there be public disclosure of significant short positions? (8) Do you agree with the methods of notification and disclosure suggested? (9) If transparency is required for short positions

³ Option A is to apply the approach suggested by CESR to all types of financial instruments that are admitted to trading on a trading venue in the EU. Option B is to apply the transparency regime proposed by CESR only to EU shares and to introduce a regime for notification to regulators of significant net short positions relating to EU sovereign bond issuers.

relating to sovereign bonds, should there be an exemption for primary market activities or market making activities?

The Eurosystem agrees with the proposal for notification to regulators of net short positions in EU sovereign debt (including through the use of CDS), as appropriate response to the threats to financial stability that large shorts could produce. Nevertheless notifications could be followed by public disclosures through the competent authorities in case suspicious activities (defined as repetitive and large shorts in one market, making it similar to tentative market manipulation) are detected. Notifications and disclosures should cover both cash bond markets and CDS in order to avoid regulatory arbitrage whereby naked shorts via CDS are entered into instead of cash bond positions in order to avoid the notifications. Such notifications would also increase transparency in a market that is largely opaque and functioning on an OTC basis.

Market making activities, if not exempted, should be reported separately, but should in any case be clearly defined so as to avoid (i) exempting from reporting the proprietary business of a market maker and (ii) ambiguous reporting. Therefore a restrictive definition of market making should be retained, whereby only actions clearly corresponding to the obligations of the market maker should be exempted. This implies clear and validated reporting procedures as well as portfolios and booking architectures whereby deals are clearly identified and cannot be re-booked easily unless notifications to the regulatory authorities are made. On primary market, market makers or bond underwriters should have the ability of going short as well in order to stabilise the issue in the case of syndicated issues.

Furthermore, with a view to meeting the G20's commitment to promote resilience and transparency in the OTC derivatives markets and as mentioned in its recent contribution to the European Commission's public consultation on derivatives and market infrastructures⁴, the Eurosystem supports regulation in the field to provide for central counterparty (CCP) clearing for derivatives contracts (i.e. those to be defined as eligible), for the reporting of OTC derivatives contracts to trade repositories (TRs) and for the establishment of the requirements that CCPs and TRs must fulfil to ensure their safety and soundness. The ECB welcomes the general approach proposed by the Commission in respect to OTC derivatives market infrastructure and agrees, in particular, that financial market infrastructures such as CCPs and TRs are effective tools for controlling and mitigating risks in the financial system.

In light of the current EU legislative framework, it is likely that the notification of net short positions in shares is to be made to the competent authorities of the most relevant market in terms of liquidity for those financial instruments. For some euro area banks, this would mean that the disclosures may in some cases be made to authorities outside the euro area. Therefore, while the sharing of net short selling disclosure information between competent authorities is envisaged, the information should, to the extent

⁴ <http://www.ecb.europa.eu/pub/pdf/other/ecconsultationderivativesmarketinfrastructures200907en.pdf>.

possible, be made available automatically by the authorities receiving it to the “home” supervisor of each bank submitting such information.

(10) What is the likely costs and impact of the different options on the functioning of financial markets?

Costs depend heavily on the reporting model and in particular if the intention is to monitor either an overall market short position on a security, or an individual dealer’s short position on a security.⁵ See also response to question 6 above.

***Section C) Uncovered short sales* 14) Do you consider that the risks of uncovered short selling are such that they should be subject to an upfront ban / permanent restrictions? If so, why?**

Views differ about the regulatory treatment of short selling, with some highlighting the benefits in terms of market liquidity and pricing efficiency and other noting the possible negative effects on orderly market functioning. Rules also vary across jurisdictions although during the financial crisis in many countries prohibitions of (uncovered) short selling have been introduced. Limiting short selling trades reduces the amount of information contained in the stock price by means of keeping the more pessimistic investors out of the market, therefore causing prices to reflect a more optimistic valuation than they otherwise would. However, in severe market conditions certain short selling practices may increase downward market movements and lower investors’ confidence. While it may be necessary to impose short selling restrictions in times of financial crises, they should be introduced in a coordinated manner and removed again as soon as normal market conditions are re-established.

As regards uncovered or naked short selling (i.e. the practice of selling stock without having a lending party, hoping to find it later), indeed such practice could cause a number of problems, such as a risk of settlement failures. Therefore there is consensus at international level that appropriate controls should be in place to reduce or minimise the possible risks for the efficient and orderly functioning of financial markets. In this context, while a complete ban on naked short selling might potentially reduce the possible risks for the markets, the potential adverse effects of such a very restrictive measure should be carefully

⁵ In particular, in case of market short position on a bond: at dealers level, each uncovered short sale should be flagged in the systems: this is costly and relies upon the dealers or the brokers, and aggregated at the market level in order to show whether or not a bond is affected at large by short selling, which entails heavy costs to process such a flow of data. In case of individual dealers short positions going beyond certain thresholds: those would have to be signalled by the dealer running the short position when certain thresholds are breached, which is less costly and easier to implement.

considered. In particular, it should be recognised that such activity may be performed by market makers in their normal activity in case they do not have at disposal the securities requested to them.

Regulators should be attributed adequate powers to impose a temporary ban in order to react to extreme circumstances whereby the broad market positioning negatively impacts on the issuer. If significant market speculation led by short sellers can be evidenced in future situations, a temporary short selling ban on both sovereign cash bonds and CDS markets could in such cases be agreed upon..

MARKET EVIDENCE: Evidence of naked short sales driving underlying prices out of control is not easy to gather. It is currently impossible to know which dealers are using uncovered short sales in their trading, and to what extent. Potentially almost every dealer has certainly been using such trading practices, but with probably very tight limits given the risks associated with such positions. At this stage further analysis would be welcome as it would give a starting point with which reporting on short positions could be compared.

(13) Do you agree with the proposed rule setting out conditions for uncovered short selling? Do you consider that more stringent conditions could be put in place? If so please indicate which ones? Do you agree that arrangements other than formal agreements to borrow should be permitted if they ensure the shares are available for borrowing at settlement? If so, why? (15) Do you agree with the proposal requiring buy in procedures for settlement failures due to short sales? If so, what is an appropriate base period that could be specified before buy in procedures are triggered (e.g. T + 4)?

The consultation document provides that a person would not be allowed to enter into a short sale unless the person has borrowed the share, entered into an agreement to borrow it or has evidence that it will be able to borrow the share at the time of settlement. Under normal circumstances short sales are one way of providing market liquidity hence imposing conditions on this might be counterproductive. In crisis situations evidence of borrowing agreements could be requested from dealers having reported net short positions and those agreements should be closely investigated.

In the bond market, settlement failures are very costly on the first day of the settlement failure. For example in the futures markets penalties for failing to deliver the bond at the exchange delivery date are particularly high and imposed by the exchange to the clearer that passes on the cost to the defaulting client. As is the case with futures markets, higher penalties could be envisaged or investigated in relation with clearers or central counterparties for other market segments as far as those rules do not already exist. Moreover, in all the Member States the effective enforcement against settlement failures should be ensured. Finally, depending on circumstances other pre-settlement or settlement enhancing methods could

be also effective in reducing fails, particularly when determined by (non-abusive) short sales (e.g. availability of centralised securities lending facilities, triparty repo facilities, partial settlement).

(16) Do you consider that there should be permanent limitations or a ban on entering into naked credit default swaps relating to EU sovereign issuers? If so, please explain why, including if possible any evidence relating to the use of naked CDS. (17) Do you consider that in addition to the measures described above there should be marking of orders for shares that are short sales?

As mentioned above, limitations or bans should be limited in time and in scope in case of exceptional circumstances. Similarly CDS should not be subject to such permanent limitations as these instruments allow hedging and contribute to market liquidity overall.

A marking of orders that are short sales ('flagging') in addition to the proposed notification of (end of day) net short positions to the regulator would in principle be useful to gain information about intraday short sales, which would otherwise remain opaque. This could facilitate a timely reaction of competent authorities to disorderly activities. On the other hand, a "flagging"-regime would not cover shorting through derivatives, would be costly to implement and would not necessarily allow the calculation of outstanding short positions. With regard to the other instruments proposed, in particular the notification of net short positions to the regulator and measures to prevent settlement failure, an additional "flagging" of short sales currently seems dispensable.

Section D) Exemptions

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

See the reply to questions 7-9.

Section E) and F) Powers of competent authorities

(22) Should the conditions for use of emergency powers be further defined?(23) Are the emergency powers given to competent Authorities and the procedures for their use appropriate?(24) Should the restrictions be limited in time as suggested above?(25) Are there any further measures that could ensure greater coordination between competent authorities in emergency situations?(26) Should competent authorities be given further powers to impose very short term restrictions on short selling of a specific share if there is a significant price fall in that share (e.g. 10%)? (27)

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

The Eurosystem broadly supports the intention of the Commission to provide that competent authorities would be given adequate powers to impose temporary restrictions on short selling and CDS transactions in emergency situations along the line proposed in the consultation document. In particular the authorities should be empowered to conduct on-site inspections. Moreover, the ECB/Eurosystem notes that the ESMA, when established, should play a central role in relation to actions undertaken in emergency situation to restrict short selling, in cooperation with the other European Authorities and the ESRB as appropriate. However, in such emergency situations, national authorities should be able to act as rapidly as possible, while notifying the ESMA of the intended measures. Finally, central banks' interest as overseers in fails affecting settlement discipline should be considered. Fails monitoring is an oversight requirement (under ESCB-CESR recommendation 3). Therefore, as the fails can be relevant for smooth settlement of SSSs and even for issues concerning timely delivery of collateral, in case of fails (potentially) affecting settlement discipline central banks need to be involved as they could have relevant information to assess the situation.