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FESE Response
EUROPEAN COMMISSION PUBLIC CONSULTATION ON SHORT SELLING

I. Introduction

The **Federation of European Securities Exchanges** (FESE) represents 45 exchanges in equities, bonds, derivatives and commodities through 20 full members from 29 countries, as well as 7 Corresponding Members from European emerging markets. FESE is a keen defender of the Internal Market and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE represents public Regulated Markets. Regulated Markets provide both institutional and retail investors with transparent and neutral price-formation. Securities admitted to trading on our markets have to comply with stringent initial and ongoing disclosure requirements and accounting and auditing standards imposed by EU laws.

We understand the rationale behind the measures taken by the authorities as extreme market conditions triggered extreme responses to seek to restore confidence in the markets. However, notwithstanding the laudable intentions, the restrictions imposed by several authorities in the EU have been both discriminatory, because of their scope of instruments and venues, and ineffective. Studies[1] demonstrate that short-selling prohibitions reduced market liquidity - especially for stocks with small market capitalization, high volatility and no listed options - and the extent to which prices reflect private information. Moreover, bans on short-selling slowed down price discovery, especially in bear market phases. To avoid similar situations in the future, we support a strong co-ordinating role to be given to ESMA to ensure that a consistent approach is taken by the relevant Competent Authorities (CAs) across all venues trading the same product.

As the Commission rightly points out, short selling plays a positive and important role in financial markets. More than enough evidence exists to prove that the possibly speculative actions that have recently triggered local restrictions have primarily been conducted using instruments that were not admitted to trading on Regulated Markets but that were traded OTC.

II. Responses to the Commission's Questions

A. SCOPE

Questions:

(1) Which financial instruments give rise to risks of short selling and what is the evidence of those risks?
(2) What is your preferred option regarding the scope of instruments to which measures should be applied?
(3) In what circumstances should measures apply to transactions carried on outside the European Union?

We do not specifically accept that there are material risks of short selling either generally or in relation to specific instruments.

[1] Kolasinski, Reed, Thornock "Prohibitions versus Constraints: The 2008 Short Sales Regulations" – October 2009; Beber, Pagano "Short-Selling Bans around the World: Evidence from the 2007-09 Crisis" – January 2010

Short-selling increases liquidity and leads to more efficient price discovery, which in turn facilitates hedging and risk management by market users. Furthermore, naked short selling on an organized and Regulated Market appears not to be a problem.

However, the relevant speculative actions appear to have been conducted using instruments not admitted to trading on a Regulated Market and have been traded OTC without transparent or enforceable settlement arrangements. Policy focus should therefore be on OTC products traded in the OTC space.

With this background in mind - and considering that we believe that there is not enough established evidence that short selling needs regulatory measures as those proposed in the Consultation Paper - FESE Members would not oppose the proposal to require private reporting of significant short positions to the CAs. Private reporting to CAs would represent a valuable tool to gain information on market movements only if applied in a non-discriminatory way.

However, in order not to distort competition and the level playing field, **proportionate measures should be applied in a non-discriminatory way to all venues but restricted to specific types of instruments**. The real challenge for regulators will be that of ensuring a level playing field in which risk is well managed by the authorities.

Finally, the scope should include instruments that are used for the purpose of short-selling activities – therefore, other than shares, CDS and derivatives on single stocks should be included in the new regime. On the other hand, derivative instruments whose underlying is a commodity, an index or a fixed-income instrument should not be included in the scope because they serve a different function.

Considering the above, if measures are to be introduced at all, we would prefer an option closer to B – that is, applying the rules uniformly to instruments admitted to trading on a RM and on an MTF and to CDS and derivatives on single stocks.

However - should these measures be introduced - we would like to reiterate that to have the intended effect the proposed measures would need to apply also to positions taken outside regulated trading venues. If the OTC market is not within the scope of the short selling regime, the intended effects will not be obtained and as consequence transactions will be driven onto unregulated venues. The measures would run counter to the intentions expressed by G20 and EU and global institutions to increase transparency and reduce the opacity of markets. Furthermore, if measures are introduced that place a burden on those that make use of regulated venues, this would affect the level playing field vis-à-vis OTC markets. It seems most relevant to focus measures on OTC markets rather than on practices taking place on regulated venues, if any measure is taken.

Finally, in relation to Q3, any measure imposed in relation to an instrument admitted to trading on a RM within the EU needs to apply to this instrument irrespective of where a transaction is carried out otherwise there would be a risk of regulatory arbitrage and the EU measures will not have the intended effect. This also applies in reverse to instruments admitted outside the EU but traded within the EU. In addition, measures limited to regulated venues may incentivize OTC trading, thus favouring the more opaque trading venues over the transparent venues.

B. TRANSPARENCY

Questions:

(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?
(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?
(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 relating to sovereign bonds, should there be an exemption for primary market activities or market making activities?
(10) What is the likely costs and impact of the different options on the functioning of financial markets?

Concerning the scope for instruments, it is important to ensure a fair and balanced approach. In order to achieve this, all instruments - not only those admitted to trading on a trading venue in the EU - should be subject to the transparency regime. Otherwise, some instruments like CDS would be left outside of the scope. Hence, we believe that the transparency regime would be most effective if **Option A was extended also to instruments not admitted to trading on a trading venue in the EU**. In particular, for shares admitted to trading on a RM, the right approach would be that of treating the instrument in terms of where it is traded and not only of where it is admitted to trading. We must avoid situations in which unfair advantages are provided to private OTC markets vis-à-vis RMs (and MTFs).

In the case of commodity derivatives, we do not believe that the short-selling regime should apply to commodity derivatives as there is no evidence to suggest that short selling is detrimental to the operation of these markets. Far from being detrimental, short selling is essential for the proper functioning of these markets. Hence, the preferred option of FESE members is that commodity derivatives are not included in the scope of instruments to which measures should be applied. We assert that the type of transparency proposed would bring no benefits to these markets, would be disproportionate and therefore would prefer if the proposed new transparency requirements were not applied.

Notifications of significant net short positions, however, should be private, i.e. limited to the CA and not public, i.e. it should not be disclosed to the market.

On reporting to the regulator, the Transaction Reporting System and the Officially Appointed Mechanisms could provide a good structure to build on.

With regard to a possible exemption for primary market and market making activities, we believe that exemptions should be foreseen to ensure that liquidity providers are not limited in performing a key function for the market.

On costs, it is generally very difficult to estimate them. A regime that misses the goal will add cost and administration without achieving a benefit.

C. UNCOVERED SHORT SALES

Questions:

(11) What are the risks of uncovered short selling and what is the evidence of those risks?
(12) Is there evidence of risks of uncovered short sales for financial instruments other than shares (e.g. bonds or sovereign bonds), which would justify extending the requirements to these instruments?
(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?
(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?
(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)? (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?
(18) What is the likely costs and impact of the different options on the functioning of financial markets?

It is important to reiterate that short selling is a useful feature in financial markets. Disproportionate restrictions will curb liquidity, which will cause the costs of legitimate activities will increase. Moreover, even if a position may be naked at the point of selling, it is not a given that there will be a settlement failure. By introducing restrictions applicable at the point of selling perfectly legitimate transactions will be unduly restricted.

Q11 & Q12
There is no evidence of risks. It is also worth pointing out that for transactions cleared through a central clearing house, there are already default regimes in place via the CCP to ensure settlement occurs. Instead of regulating naked short selling, it would be more appropriate to concentrate on encouraging CCP clearing.

FESE members believe that a ban or permanent restriction on short-selling or uncovered short-selling may not be adequate. Such a ban would be particularly ineffective because the instruments it might cover (i.e. CDS) are not traded on Regulated Markets and are not subject to appropriate transparency and oversight rules.

FESE members believe that there is no evidence to suggest that uncovered short sales on commodity derivatives markets are detrimental to those markets. Its members consider that the nature of price hedging means that commodity producers and consumers would be unable to hedge their price risk if they were unable to make uncovered short sales on regulated markets that list commodity derivatives.

Q13
No. From our experience, delivery may very well take place even though the seller may not own/borrow the instrument at the point of sale. Setting conditions risks having an unintended restrictive effect on short selling. If the purpose is to reduce price volatility, conditions for short selling will not have any effect. There should be no conditions. It is better to encourage CCP clearing as mentioned above.

It should be noted that the conditions set above overlook the evidence that other arrangements exist which ensure that shares will be delivered at the time of settlement.

Q15

The proposal to require buy-in procedures for settlement failures due to short sales does not look sensible as it is it is difficult to identify a short sale at the settlement layer. There are many reasons why a trade may fail to settle (insufficient stock, insufficient cash, failure of a client to deliver a purchase resulting in a market fail on the sell side, etc.). If short sale had a specific transaction indicator then this may be possible but buying in after the event has no impact on the short sale itself. It is also possible that a short sale is covered but still fails to settle because it is increasingly difficult in omnibus settlement accounts to guarantee settlement of individual trades.

It is also worth pointing out that there are already default regimes in place for transactions cleared through a CCP. Instead of regulating naked short selling, we believe it would be more appropriate to concentrate on encouraging CCP clearing.

D. EXEMPTIONS

Questions:

(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?

We understand the rationale behind the proposal to exempt market making activities from the reporting regime. It is true that market makers and liquidity providers serve a key function in our markets (i.e. that of providing liquidity and ensuring a more effective price discovery by reducing the spreads). However, exemptions should cover market makers to a very limited extent in order to not create undue differences between market making and other trading. In order to avoid an unlevel playing field in which those markets without a market maker could unfairly benefit from the new regime, we believe that it is necessary to apply a very narrow definition of 'market maker'.

The exemption for market-makers cannot be limited to trades involving a particular instrument, for which the market-making is carried out. Rather, the market-maker must be granted comprehensive exemption from a potential ban, since, in practice, transactions are not limited to those securities for which market-making is conducted but often extends to related and associated instruments.

A comprehensive exemption for market-makers is also not a source of risk, since, in our experience, market-makers tend to close out their short-sales within a short period of time or have comprehensive borrowing arrangements in place to ensure market settlement is fulfilled. It contradicts the very nature of market-making to leave positions open for a longer time.

E. EMERGENCY POWERS OF COMPETENT AUTHORITIES

Questions:

(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%)?

Where appropriate – that is, in truly exceptional market circumstances - we would support a role for ESMA in coordinating the emergency powers of CAs but, to avoid the mistakes made in 2008, 2009 and 2010 where bans on short selling have been imposed inconsistently and unfairly, we stress the importance of ensuring that the rules on emergency powers, when invoked, are implemented in a harmonized manner across the EU and that cross-border effects are addressed properly.

This coordinated approach should be as detailed as possible and be facilitated by ESMA and applied consistently across Europe. The period of not less than 24 hours before the measure takes effect or be renewed might be too permissive.

As a preliminary and indicative list, we suggest that the following standards are considered by the CAs when using these emergency powers:

1. Set a high bar for intervention – "exceptional market circumstances"
2. As applied in case of "conditions that can demonstrably be traced back to short-selling"
3. Must be targeted "specifically at an instrument, rather than universally"
4. Must be "subject to time limits" and thereby subject to "an ongoing review of their necessity"
5. In the interests of ensuring a level playing-field and the integrity of the European financial market as a whole "unilateral efforts at regulation by individual member nations" must not be allowed.

F. POWERS OF COMPETENT AUTHORITIES

Question:

(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?

It should be ensured that all competent authorities have the same powers to seek further information regarding any supervisory purposes. It seems that the suggestion in the consultation paper to give powers to competent authorities for the purposes of identifying anyone entering into a CDS transaction is related to the general aim to ensure financial stability. If so, the powers for competent authorities should be looked at more broadly than only in relation to the purpose of entering into a CDS transaction.

Q 27

There is no support for the view that restrictions on short selling are an appropriate measure. For this reason, we object to introducing powers to impose such restrictive measures. Should nevertheless such powers be introduced, they should be limited to emergency cases only. However, before this is introduced, a consultation on what may constitute such emergency cases should be carried out.

Q 28

Competent authorities need to have the powers to enforce any rules applying to financial market participants, be they stated in EU law, in national regulations or imposed in the form of emergency measures. This is crucial in order to ensure that the rules are complied with uniformly.

Q 29

In relation to short selling, coordination powers should be strong in order to ensure harmonized regulatory solutions across the EU. The current coordination by CESR in relation to short selling has not achieved a harmonized solution. Emergency powers should be decided unanimously by the competent authorities. This requires coordination by ESMA.

G. GLOSSARY OF DEFINITIONS

Question:

(30) Do the definitions serve their intended purpose?

To complete the glossary, we suggest:

- Defining 'person'
- Defining 'market maker'
- Defining 'principal market' in more detail, or at least the process of finding the principal market should be described or referred to
- In relation to 'Short sale':
  - 'the time of the sale' may need to be specified, possibly 'the time of entering into the agreement' is better.
  - In relation to derivatives, a separate definition may be needed. It does not seem to be relevant to demand that the underlying security be held from the time of entering into a derivatives contract until delivery.