

Is the European Short Selling Regulation a Justifiable
Response to the Concerns Posed by Short Selling?

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Thesis submitted for the degree of Doctor of Philosophy

Trinity Term 2015

To my husband, Peter

Acknowledgements

I am indebted to my supervisor, Professor Jennifer Payne, for her expertise, advice and encouragement over the last three years. Without her support, none of this would have been possible. I have had many helpful and thoughtful discussions with a wide range of experts and would like to record my thanks in particular to Professor John Armour, Professor Luca Enriques, Professor Larry Glosten and Professor Pierre-Henri Conac. I also gratefully acknowledge the financial support of the Carnegie Trust.

I would like to thank my family and friends for all their encouragement and motivation. I am especially indebted to my husband, Peter. This doctorate could not have been written without his continued patience, humour, support and interest in my work over the last three years.

Abstract

Short selling came onto the centre stage during the recent financial crisis when the collapse in price of financial listed securities after the demise of Lehman Brothers led to the introduction of a number of temporary short selling bans. In Europe however it was the commencement of the recent European sovereign debt crisis that was the true stimulus for proposing new short selling rules, the culmination of which was the introduction of the European Short Selling Regulation (the ‘Regulation’).

The thesis asks whether the Regulation is a justifiable response to the concerns posed by short selling. Such issues are measured against the relevant economic literature that almost overwhelmingly demonstrates that short selling contributes to market efficiency, that restrictions generally make markets less efficient and that constraints do not achieve the desired objective of stabilising prices. The thesis then analyses the political economy and backdrop to the Regulation’s introduction that largely dictated the shape of the final rules. The precise legislative choices made by Europe, including with respect to sovereign credit default swaps, are analysed, and (where relevant) there is a comparative element with a consideration of the US short sale regulations. These rules are used as a contrast and as a means of commenting more effectively on the European provisions.

The doctorate concludes that the Regulation is not a justifiable response to policymakers’ concerns and that the rules have suffered from the politicisation of the legislative process. The thesis suggests that short-term political point scoring has triumphed over the long-term benefits of market efficiency and that short sellers are now the subjects of highly technical rules that will negatively impair on market efficiency. Although, with time, parties may learn to use the new rules to their advantage, this does not justify the introduction of unreasonable rules in the first place.

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Table of Abbreviations

Term	Abbreviation
Credit Default Swap	CDS
Committee of European Securities Regulators	CESR
European Court of Justice	ECJ
European Securities Markets Authority	ESMA
European Short Selling Regulation	The Regulation
European Commission	The Commission
Fail-to-Deliver	FTD
Financial Services Authority	FSA
International Organisation of Securities Commissions	IOSCO
National Competent Authority	NCA
Over-the-Counter	OTC
Securities and Exchange Commission	SEC

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Chapter 1: Introduction

1.1 Overview

‘Short selling has been characterised as in-human, un-American, and against God (Proverbs 24:17: “Do not rejoice when your enemy falls, and do not let your heart be glad when he stumbles”).’¹

Short selling is a sensitive subject. Setting aside moral concerns about selling something one does not own, short sellers provide convenient targets for criticism as they are in a sense seen as betting against the team: they allow investors to profit when the share price falls.² During the recent financial crisis, the price collapse of listed financial securities following the demise of Lehman Brothers brought the issue of regulating short selling onto the centre stage. Due in particular to considerable pressure from politicians, the public and the press, a number of regulators introduced temporary short selling bans. Subsequently, and in Europe particularly spurred on by the sovereign debt crisis, short selling regulation was then placed on the regulatory agenda, and in 2012 the EU adopted a Regulation on short selling (the ‘Regulation’). Given that historically, many European jurisdictions (including the UK) were not that interested in regulating short selling, this is a fairly dramatic turn of events.

¹ Owen A. Lamont, ‘Go Down Fighting: Short Sellers vs. Firms’ (2012) 2 *The Review of Asset Pricing Studies* 1, 5.

² Jonathan Macey, Mark Mitchell and Jeffrey Netter, ‘Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash’ (1988) 74 *Cornell L Rev* 799, 800.

Indeed this development is all the more remarkable when one also observes that the Regulation not only governs the short selling of shares, but also regulates the short selling of sovereign debt and sovereign CDSs. In order to fully understand the Regulation's introduction, it is important to keep in mind the wider European agenda and to recognise that the politicisation of regulation increased in the light of the financial and sovereign debt crises. Specifically, it often takes a financial crisis or a scandal to provide the impetus to instigate financial reforms, and such changes are often a 'knee-jerk' response that may have little true connection to the crisis itself. With respect to the EU, the crisis prompted it to embark on a path of greater integration and of 'more' rather than less Europe.³ A huge programme of reforms followed, characterised by greater harmonisation, an expansion of the regulatory perimeter and further centralisation of powers at the EU level. In particular however, many of these new measures also sought to regulate actors and practices that had been perceived to constitute a threat to market stability.⁴ This included restricting the practice of short selling that had come under fire from various quarters for worsening the financial and sovereign debt crises.⁵

Consequently, and with this broader European agenda in mind, the purpose of the thesis is to examine whether the Regulation is a justifiable response to the concerns posed by short selling. This is an important question, particularly as the economic and financial literature that we will analyse in Chapter 2 almost

³ FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009) 101.

⁴ Niamh Moloney, 'Reform or Revolution? The Financial Crisis, EU Financial Markets Law, and the European Securities and Markets Authority' (2011) 60 ICLQ 521, 524.

⁵ See e.g. Nikki Tait, 'Brussels in Bid to Tame 'Wild West' Markets' *The Financial Times* (16 September 2010).

overwhelmingly demonstrates that short selling has many benefits and that short selling restrictions generally make markets less efficient. Equally, when we analyse the legislative process behind the Regulation's introduction in Chapter 3 we will further explore the politicisation of the EU's reform agenda and the considerable influence that various Member States and European institutions had on shaping the ambit of the final rules. Chapters 4 to 6 then analyse and critique the European provisions now in place that encompass short selling restrictions (including with respect to the sovereign CDS market), tighter settlement rules, private and public disclosure requirements, and a range of powers for NCAs and ESMA in emergency situations. The discussion also involves (where relevant) a comparative element with a consideration of the US provisions that provide an important counterpoint from which to comment more effectively on the European provisions.

The thesis demonstrates that the Regulation is not a justifiable response to the concerns posed by short selling and that the pursuit of short-term political goals has resulted in a complex web of provisions that impede valuable short selling activity. Indeed the economic evidence that we will consider in Chapter 2 largely endorses the importance of short selling activity for efficient markets and also illustrates that short selling restrictions do not achieve their goal of artificially supporting prices. Further, although the tighter settlement mechanisms introduced in the Regulation can be broadly supported as a sensible means of tackling the risk of settlement disruption, this issue is now the subject of wider European rules on securities settlement that repeal the short selling provisions. Next, although the Regulation's private reporting provisions can in theory assist the regulator in monitoring for unusual behaviour, such rules may prove to be of limited use in practice. Likewise the Regulation's public

disclosure rules also have a considerable number of downsides and constitute a de facto short selling restriction above the public disclosure threshold. Further, the NCA's emergency powers have caused a range of implementation issues in practice, and (as we will particularly discuss in Chapter 4) the conferral of wide-ranging powers on ESMA is a new and controversial development that also has implications beyond short selling regulation.

Chapter 1 now sets the scene for future chapters. It provides an overview of short selling, observes who engages in the practice, and considers some empirical data as to its actual incidence. Further, to help guide the reader in discussions in subsequent Chapters, it includes a short overview of the contents of the Regulation and details the thesis' methodological choices.

1.2 What is Short Selling?

Definition

Short selling can broadly be defined as the sale of a security not owned by the seller in the hope that an identical security can be bought back later for a lower price. The definition varies although IOSCO takes the view that whether a particular transaction is a short selling activity depends on the presence of two factors: (i) a sale of stock that (ii) the seller does not own at the point of sale.⁶

⁶ IOSCO, 'Regulation of Short Selling, Consultation Report' (March 2009) 8 and Appendix III.

Short selling can also be divided into two types: (i) ‘covered’ or conventional short selling where the security is borrowed, or adequate arrangements are made to ensure it can be borrowed before the short sale is executed; and (ii) ‘naked’ or ‘uncovered’ short selling where no prior arrangement has been made to cover the short sale.⁷ With naked short selling the investor sells the securities before borrowing the securities or making arrangements to ensure they can be borrowed, and this is possible because there is a gap of time between the agreement to transfer the securities to the buyer for a particular price and the actual payment and transfer. The gap enables the investor to go into the market and purchase the shares to deliver to the buyer before the end of the settlement period.

With covered short selling, being required to first borrow the securities introduces a natural limitation of 100 per cent of the issued shares of the firm that can be shorted at any time and inhibits the speed and extent of the short selling.⁸ In contrast, as naked short sellers are not constrained by the requirements to cover the short sale before trading, they can short sell as quickly as they can find buyers and can also short sell over 100 per cent of the company.⁹ As it can take place more vigorously than covered short selling, concerns tend to focus particularly on the need to restrict naked short selling, and the Regulation introduces a de facto ban on naked short sales. Nevertheless, as we will discuss in subsequent Chapters, despite regulators’ preoccupation with naked short selling, it is not a special case and there are not stronger justifications for its regulation.

⁷ Ibid Appendix III.

⁸ John Armour and others, *Principles of Financial Regulation (Draft Version)* (OUP forthcoming 2016) ch 8, 18-19.

⁹ FSA, ‘Short Selling Discussion Paper 09/1’ (2009), 11.

Short and Long Selling

Short selling should also be distinguished from long selling. Long selling is the more conventional practice of investing: if an investor buys securities and plans to sell the securities in the future for a profit this is described as taking a long position or going long.¹⁰ By contrast short selling involves the investor betting that the price will fall and making money when this happens. Short selling presents only limited opportunity to make a gain, a short sale can yield no more than the short sale proceeds (the value of the security when sold short less any fees incurred).¹¹ However short selling presents the risk of unlimited losses, a short seller can potentially lose an infinite amount if the price rises.¹² In contrast long sellers can reap an unlimited profit. Additionally the losses are fixed in that the most the investor can lose is limited to the purchase price of the securities provided the principle of limited liability is upheld.¹³

Regulators have not been particularly interested in regulating long sellers.¹⁴ Historically, long positions tended to be admired as investments while short positions were regarded as speculation.¹⁵ Nonetheless optimistic noise traders¹⁶ can pose a

¹⁰ Armour and others (n 8) ch 8, 14.

¹¹ Michael Powers, David Schizer and Martin Shubik, 'Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales' (2003) 57 Tax L Rev 233, 241.

¹² Ibid 234. See e.g. Armin Kammel, 'The Dilemma of Blind Spots in Capital Markets - How to Make Efficient Use of Regulatory Loopholes?' (2009) 10 German LJ 605 in relation to such a situation involving Volkswagen and Porsche.

¹³ Armour and others (n 8) ch 8, 15.

¹⁴ Note that concerns have been raised about long sellers who are very short term in their perspective, but this has not resulted in regulation. See e.g. Kay J, The Kay Review of UK Equity Markets and Long-Term Decision Making (July 2012).

¹⁵ Powers, Schizer and Shubik (n 11) 248. There are disclosure rules that exist regarding long positions (for instance disclosure requirements are triggered when shareholdings in listed companies exceed a particular level, and there are also obligations on directors to disclose their dealings in their company's

particular threat to markets. For instance long traders who bid up the price of a security can create market bubbles that will only be averted or mitigated if sophisticated investors sell short.¹⁷ Equally, if short sales are also restricted this will force pessimistic investors out of the market, leaving only optimistic investors to influence the price.¹⁸ Further, as we will consider in Chapter 2, it was long rather than short sellers who accounted for most of the downward price pressure during the recent financial crisis although, in contrast to short selling, no additional regulations on long selling have since been introduced.¹⁹ Consequently, as we move through the thesis, it will be suggested that there is no justification to the different approach European policymakers have taken to short rather than long selling.

1.3 Who Engages in Short Selling?

shares). These rules derive more from a mergers and acquisitions perspective, although the obligations on directors to disclose their dealings can also be viewed as a means of regulating insider dealing.

¹⁶ Broadly, noise traders act irrationally, trading on, amongst other things, unsound information rather than paying attention to the security's real value.

¹⁷ Bubbles are bad as securities are pushed above their fundamental value and as positive momentum increases, the volume of noise trading increases as more traders buy based on relatively unchecked positive momentum. Although a tipping point will be reached and prices will return to normal, the decrease in stability will be detrimental, Kevin A. Crisp, 'Giving Investors Short Shrift: How Short Sale Constraints Decrease Market Efficiency and a Modest Proposal for Letting More Shorts Go Naked' (2007) 8 *Journal of Business and Securities Law* 135, 141-2. See also discussion in Chapter 2.2.1.2.

¹⁸ Eli Ofek and Matthew Richardson, 'Dotcom Mania: The Rise and Fall of Internet Stock Prices' (2003) 58 *J Fin* 1113, 1116. For example at the turn of the century during the speculative bubble in internet stocks, many start-up firms with no earnings attained high valuations due to a combination of overly optimistic long investors willing to pay high prices for internet stocks and the existence of short sale constraints.

¹⁹ For example following the recent financial crisis a study by the US Office of Economic Analysis concluded that long rather than short sellers accounted for most of the downward price pressure on financial sector stocks, Office of Economic Analysis, 'Analysis of Short Selling Activity During the First Weeks of September 2008' (2008) . This is also discussed further in Chapter 2, see section 2.2.2.1.

Short selling can involve a short sale in the cash market,²⁰ or can be achieved through the use of derivatives. Although commonly linked with hedge fund activity, a number of other market participants (including traditional fund managers, market-makers and individual investors) may also make use of it.²¹ The practice is used for a variety of purposes including hedging (i.e. to hedge risk by taking a short position in a comparable share in which they hold a long position); speculation (i.e. as a strategy to profit from a price decline); and for arbitrage (i.e. combining a short and a long position on two different but inter-related shares to profit from the pricing differential).²² Market-makers will also use it to fill client orders (for instance when the share is not immediately available).²³

Despite its range of purposes and possible market participants (although perhaps unsurprisingly) it was the negative association between hedge fund activity and short selling that emerged in the light of the financial crisis. This was especially due to the involvement of hedge funds in short selling that was popularly perceived to have amplified price falls during the crisis. In terms of the European reform agenda, short selling subsequently became intertwined with the negotiations on the extremely contentious Alternative Investment Fund Managers Directive ('AIFMD'), where the European Parliament (the 'Parliament') expressed a particularly hostile view on

²⁰ I.e. the exchange of shares and money takes place in the present (in contrast exchanges in the futures market occur at a specified future date).

²¹ FSA (n 9) 7-8. Although note that pension funds and insurance companies more commonly purchase shares and hold them for the long-term.

²² European Commission, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps SEC(2010) 1055 11.

²³ Ibid 11.

naked short selling, proposing that it be banned throughout the EU.²⁴ As we will further discuss in Chapter 3, the commencement of the sovereign debt crisis then injected fresh energy into the issue of short selling regulation with the Parliament again championing its anti-speculation agenda, and extending the ambit of the proposed rules and restrictions into the sovereign debt markets.

Empirical Evidence

Turning to the empirical data, as short selling regulation was not common in the EU prior to the crisis, there was a lack of concrete evidence on short selling volume. Specifically, in drawing up the proposal for the new European rules, the Commission struggled to estimate the amount of short selling taking place, and had to draw particularly on British and Spanish securities lending data (such data can serve as a proxy for short selling).²⁵ According to these sources, short selling in shares could be estimated to represent between 1 and 3 per cent of EU market capitalisation.²⁶ Further, evidence in relation to the sovereign CDS market (that was added to the regulatory mix in the light of the sovereign debt crisis) was also very limited particularly due to the over-the-counter nature of this market where most participants

²⁴ European Parliament Committee on Economic and Monetary Affairs, *Report on the Proposal for a Directive on Alternative Investment Fund Managers* (A7-0171/2010) 12-13; Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 544.

²⁵ Impact Assessment (n 22) 11-13.

²⁶ *Ibid* 13. Note that in contrast, in the US, some prior academic studies estimated that short selling in the US accounted for more than 20 per cent of trading volume, see Ekkehart Boehmer and Juan (Julie) Wu, 'Short Selling and the Price Discovery Process' (2013) 26 *Rev Fin Stud* 287. However, recent analysis by the SEC estimated that orders marked 'short' accounted for approximately 50 per cent of listed equity trading volume. As we will observe in Chapter 5 however, this may be an over-estimation as marking orders is complex and SEC guidance also errs on marking orders as short.

(typically dealers) take up their positions in auctions and then maintain them in secondary markets.²⁷

More generally and as we will explore further in Chapters 2 and 3, there was also a lack of comprehensive empirical evidence as to the risks posed by short selling. The empirical literature also demonstrated that there was little convincing evidence that short selling restrictions helped support prices and prevented price declines, and that constraints could also damage market efficiency and impair liquidity. There was also very limited evidence on the imposition of prohibitions on the short selling of sovereign debt and on entering into ‘naked’ or ‘uncovered’ sovereign CDS transactions (functionally equivalent to short selling the underlying bonds). Further, as we will consider in Chapter 5, although some prior evidence existed on the impact of reporting requirements on the short selling of shares, this also lacked a firm empirical footing and did not extend into the sovereign debt markets.²⁸

Feedback to the Commission’s short selling consultation rightly highlighted significant industry disquiet in this regard.²⁹ Indeed, the absence of comprehensive evidence as to short selling’s risks adds considerable weight to the suggestion that the proposal derived more from the politicised environment and the pressure on

²⁷ ESMA, ‘Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263’ (April 2012) 51.

²⁸ See e.g. CESR, ‘CESR Proposal for a Pan-European Short Selling Disclosure Regime’ (July 2009) 10-11.

²⁹ See e.g. ICFR, *Response to Short Selling Consultation* (2010); Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) (n 24) 547-8.

regulators to be seen to be acting,³⁰ than any clear empirical findings. This situation was also then further exacerbated by concerns in some countries (supported by the Parliament) as to the perceived impact of speculation in aggravating the sovereign debt crisis.

1.4 Overview of the Regulation

Turning to consider the European rules, the Regulation's scope is widely drawn: domicile or establishment is irrelevant and the territorial scope is defined by the nature of the financial instruments traded, not the person's location.³¹ Consequently, the rules have extra-territorial scope where short selling activities relate to 'in-scope' financial instruments.³² Nevertheless despite its wide scope, the reach of the rules is then largely directed towards the short sale of shares, sovereign debt, and sovereign CDSs.

The Regulation draws a fundamental distinction between covered and naked short sales and at the Regulation's heart is a de facto prohibition on naked short sales of shares and sovereign debt, and a prohibition on entering into uncovered sovereign CDSs.³³ As will be further explored in Chapter 3, the particular drive to restrict naked short selling stemmed especially from the unfounded perception that naked short

³⁰ Luca Enriques, 'Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View' (2009) 30 *University of Pennsylvania Journal of International Law* 1147, 1148.

³¹ ESMA, 'Questions and Answers: Implementation of the Regulation on Short Selling and Credit Default Swaps (2nd Update) 2013/159' (January 2013) question 1a.

³² Moloney (n 24) 551. Note that extra-territorial reach is not uncommon in short sale regulation.

³³ Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, arts 12-14.

selling was a wicked type of speculation that could endanger a financial system or a country's economic stability. In addition, the related rules that dictate whether transactions are covered and thereby permitted were also the subject of highly politicised debates during the Regulation's protracted negotiations.³⁴ In particular this has resulted in a complex set of conditions that, in part, reflect political concerns and agendas stemming from the Parliament and some Member States.³⁵ Next, tight settlement rules for shares have also been introduced to tackle the risk of settlement failure that can arise particularly from naked short selling.³⁶ However, as will be discussed in Chapter 4, although these provisions can generally be supported, the rules are currently in the process of being replaced by a broader set of European rules on securities settlement.

Accompanying the restrictions is a set of reporting obligations with respect to net short positions. Private and public reporting rules apply to short positions in shares (although in the case of sovereign debt only private notifications are required).³⁷ Further, in exceptional circumstances, there is also a set of far-reaching emergency intervention powers conferred on national regulators, and significantly also on ESMA.³⁸ For instance, as we will discuss in Chapter 4, ESMA has the power to directly intervene in the market and prohibit, or impose conditions on entering into a short sale (other than in relation to sovereign debt or sovereign CDSs) and such measures will prevail over measures taken by national regulators. Although there may be an important argument for a uniform cross-border approach in the event short

³⁴ Moloney (n 24) 555.

³⁵ Ibid 555.

³⁶ Regulation 236/2012, art 15.

³⁷ Ibid arts 5-7.

³⁸ Ibid arts 18-23, art 28.

selling restrictions are introduced, the extension of powers to ESMA has been controversial and has been the subject of an unsuccessful legal challenge by the UK at the ECJ. As we have touched on in this Chapter, and will explore further in Chapter 4, the case also has far broader implications, including with respect to the likelihood of further centralisation of powers at the European level.

It should also be observed here that the overall effect of the rules in practice will be weakened by the Regulation's enforcement mechanisms. Specifically the provisions on penalties and administrative measures for infringements are not harmonised and instead are broadly based on the pre-crisis approach that left the establishment and enforcement of penalties down to the Member State.³⁹ Consequently, this is likely to result in ineffective enforcement of the rules as penalties may either not be imposed or may vary considerably from country to country.⁴⁰

1.5 Methodology

Turning to then consider the thesis' precise methodological choices: the analytic framework for the remainder of the thesis is set out in Chapter 2. Specifically, using the relevant economic and financial literature, Chapter 2 examines the justifications put forward by policymakers in favour of short selling regulation and broadly suggests that pro-regulation arguments do not stand up to scrutiny. The thesis then

³⁹ Ibid art 41.

⁴⁰ See ESMA, *List of Administrative Measures and Sanctions Applicable in Member States to Infringements of the Short Selling Regulation* (September 2014). For instance fines in Belgium are not to be under 250 euro per day and are capped at 2.5 million euro in total; in contrast in France the fines can be up to 100 million euro. See also discussion in Chapter 5, section 5.2.2.

draws on political economy literature in Chapter 3 and uses this as a basis from which to explore the politicised backdrop to the Regulation's introduction. Chapters 4 to 6 then analyse and critique the legislative choices made in Europe with respect to the restrictions on the short selling of shares; the reporting requirements on shares; and the restrictions imposed on entering into naked or uncovered sovereign CDSs.

It should be observed here that the thesis focuses on the prohibition on naked sovereign CDSs rather than on the constraints on the short selling of sovereign debt. Although it is possible in principle to directly short sell a sovereign bond, purchasing a naked sovereign CDS provides a relatively simple, economically equivalent mechanism that also does not require the same outlay as purchasing a bond. Further, sovereign CDSs raise some complex and particularly interesting questions including with respect to the interaction between the sovereign CDS and the underlying bond market and their respective contributions to credit risk price discovery.

It should also be noted here that although the focus of this thesis is on the new European rules, Chapters 4 and 5 also contain a comparative element with a discussion of the relevant US rules (Chapter 6 contains no such aspect as no similar rules on sovereign CDSs were introduced in the US). The decision to consider the US rules in addition to the EU's is motivated by the fact that the US has had short selling regulations in place in one form or another since the 1930s, offering an interesting contrast to the EU. Further, the US is also the largest, most liquid equity market in the world, making it a highly relevant market to consider.⁴¹ Finally, in particular due to

⁴¹ Ekkehart Boehmer, Charles Jones and Xiaoyan Zhang, 'Shackling Short Sellers: The 2008 Shorting Ban' (2011) Columbia University Working Paper, 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1412844> accessed 19 November 2012. They also observe that it has the most short selling activity.

varying political drivers on both sides of the Atlantic following the crisis, there has also been some divergence in the approach then taken to short selling regulation. Consequently this makes it even more important to examine the relevant political backdrop in the EU and the US and to consider the resulting regulatory inconsistencies.

Keeping this introductory discussion in mind, we shall now turn in Chapter 2 to examine the justifications that are put forward by policymakers in favour of short selling regulation. As we have touched on in this Chapter, the literature almost overwhelmingly endorses short selling's benefits to market efficiency and generally finds that short selling restrictions do not achieve their intended aim of artificially supporting prices.

Chapter 2: Do the Justifications for Regulating Short Selling Stand Up to Scrutiny?

2.1 Introduction

The function of Chapter 2 is to analyse the legal and economic grounds put forward in favour of regulating short selling. It is this Chapter's contention that short selling is helpful rather than harmful to markets, and that the arguments in favour of short selling restrictions do not generally stand up to scrutiny.

As we observed in Chapter 1, short selling regulation became topical during the financial crisis in 2008, when the drastic drop in the price of listed financial securities following the collapse of Lehman Brothers ('Lehmans') was described as a 'watershed moment in the regulation of short selling'.¹ Due to considerable pressure from governments, the public and the press, regulators took the view that short selling was exacerbating the downward spiral of prices and introduced temporary short selling bans. Subsequently the regulation of short selling was placed firmly on the legislative agenda, and permanent short selling regulations have now been introduced in both the EU and the US.

This Chapter explores the validity of the various grounds put forward for regulating short selling from a legal and economic perspective. Three main issues will be explored: market destabilisation; market abuse; and settlement concerns. Contrary

¹ Emiliios Avgouleas, 'The Vexed Issue of Short Sales Regulation When Prohibition Is Inefficient and Disclosure Insufficient?' in Kern Alexander and Niamh Moloney (eds), *Law Reform and Financial Markets* (Edward Elgar 2011) 72.

to the popular view that short selling destabilises security prices,² where it is considered that in extreme market conditions short selling can trigger an excessive downward spiral of prices leading to disorderly markets and possible systemic risks,³ it will be suggested that both covered and naked short selling increase market efficiency and neither causes systemic effects. Likewise, although short selling can be used abusively, there are comprehensive market manipulation regimes in place that can address this concern. Finally, the risk of settlement failure can also be tackled more generally, rather than through the introduction of specific short selling constraints.

This Chapter analyses these three grounds with respect to both conventional and naked short selling. However, as concerns often focus on naked short selling, a separate section will also consider whether it merits a more emphatic regulatory response. However, it will be suggested that despite regulators' fixation with this form of short selling, it is not a special case, and that there are not different arguments for its regulation, just the potential for stronger versions of the same arguments. Finally, it will also be suggested that the sudden push to regulate short and not long selling⁴ has arisen not from clear legal and economic justifications but from considerable pressure from politicians, the public, and the media.

² For instance the European Commission (the 'Commission') particularly highlighted this concern in its proposal for a European Short Selling Regulation, see further Commission Proposal for a Regulation on Short Selling and Certain Aspects of Credit Default Swaps COM(2010) 482, 2.

³ Ibid 3. See also further sections 2.2 and 2.3 below.

⁴ See further Chapter 1. See also e.g. Michael Powers, David Schizer and Martin Shubik, 'Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales' (2003) 57 Tax L Rev 233. For instance, long traders who bid up the price of a security can create market bubbles that will only be averted or mitigated if sophisticated investors sell short.

2.2 Short Selling: Market Destabilisation

The utility of short selling has long been a subject of debate between those who support short selling's ability to increase market efficiency, and its critics who highlight its propensity to destabilise security prices.⁵ This section will explore two central questions in relation to market destabilisation: whether or not short selling contributes to market efficiency, and whether or not short selling can lead to systemic effects. This section will also discuss whether the short selling of sovereign debt raises different issues from the short selling of securities.

2.2.1 Market Efficiency

The pivotal question is whether short selling promotes market efficiency and has a legitimate and important role in the functioning of financial markets, or whether it interferes with market efficiency and can destabilise prices. In line with the research of the majority of financial economists it is submitted that in normal market conditions short selling promotes market efficiency: it contributes to efficient pricing, liquidity, and a more efficient price discovery process. In addition, short sale constraints generally make markets less efficient. Consequently, there is good reason to be wary of regulation that affects the efficiency benefits of short selling.

2.2.1.1 What is an Efficient Market?

⁵ Eleonora Zlotnikova, 'The Global Dilemma in Short Selling Regulation: IOSCO's Information Disclosure Proposals and the Potential for Regulatory Arbitrage' (2010) 35 *Brook J Intl L* 965, 968.

The theory of efficient capital markets, also referred to as the efficient capital market hypothesis,⁶ states that efficient markets are characterised by accurate pricing and high liquidity.⁷ In efficient markets, information about the value of firms is incorporated quickly and accurately into stock prices.⁸ For example, when rational investors learn something about the fundamental values of securities,⁹ they quickly respond by bidding up prices when the news is good and bidding them down when the news is bad. As a consequence, security prices incorporate all the available information almost immediately and prices adjust to new levels corresponding to the new net present value of cash flows.¹⁰ Another way to state the efficient market condition is that in an efficient market all unexploited profit opportunities will be eliminated.¹¹

The capital market consists of different groups of market players, including insiders, information traders, and noise traders.¹² Both insiders and information

⁶ See Eugene F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 J Fin 383; Eugene F. Fama, 'Efficient Capital Markets: II' (1991) 46 J Fin 1575.

⁷ Zohar Goshen and Gideon Parchomovsky, 'The Essential Role of Securities Regulation' (2006) 55 Duke LJ 711, 720-721. For a detailed description of how markets attain efficiency see Ronald J. Gilson and Reinier H. Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Va L Rev 549. See also Ronald J. Gilson and Reinier H. Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) 28 J Corp L 715. Note that the theoretical foundations and empirical evidence supporting the efficient markets hypothesis have been challenged, in particular by behavioural finance. See e.g. Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (OUP 2000).

⁸ Goshen and Parchomovsky (n 7) 721. The process of incorporating information quickly and accurately into prices involves information production (i.e. searching for unknown information that affects prices), verification of the information, pricing the information and then trading.

⁹ The fundamental value of a security can be described as the net present value of its future cash flows, discounted using its risk characteristics. See Shleifer (n 7) 3.

¹⁰ Ibid 3.

¹¹ Frederic S Mishkin and Stanley G Eakins, *Financial Markets and Institutions* (Pearson 2008) 159.

¹² Other groups exist, including market makers and liquidity traders, although for current purposes the focus is on insiders, information traders, and noise traders. Insiders have access to inside information due to their proximity to their firm. Information traders comprise of two subgroups, namely sophisticated professional investors and analysts, and have the ability to collect, evaluate and price information as the basis for their investment decisions. Noise traders act irrationally and follow

traders can detect discrepancies between value and price based on the information they possess and then trade to capture the value of their informational advantage (for example, selling when an overvaluation is spotted, thereby causing the price to drop).¹³ The accuracy of stock prices depends on the ability of such traders to counter the actions of irrational noise traders, and to price newly disclosed information.¹⁴ The more skilled information traders and insiders can counter price-value discrepancies caused by noise traders and will lead to a more efficient market.¹⁵

2.2.1.2 Short Selling Promotes Market Efficiency

Securities regulation, by imposing restrictions on insider trading, entrusts information traders with the role of providing efficient markets, and it is submitted that a short seller is, in the main, a type of information trader, rather than a noise trader or an insider.¹⁶ Short sellers can be regarded as particularly sophisticated investors, similar to analysts, who invest considerable time and resources analysing companies.¹⁷ As information traders, they lack access to inside information but are willing and able to

differing methods of investment either as individuals or as a group. See further Goshen and Parchomovsky (n 7) 723.

¹³ Ibid 726.

¹⁴ Ibid 729-730.

¹⁵ Ibid 730. Efficient pricing is a matter of degree: the larger the deviation between price and value, and the longer it takes for prices to revert to value, the less efficient is the market. Additionally the ability to counter price deviations will depend on the risk and cost involved in the process of locating, verifying, and pricing of information. The lower the costs of information, the more efficient will be the market. See Gilson and Kraakman (n 7) 593.

¹⁶ Goshen and Parchomovsky (n 7) 732.

¹⁷ Michael S. Drake, Lynn Rees and Edward P. Swanson, 'Should Investors Follow the Prophets or the Bears? Evidence on the Use of Public Information by Analysts and Short Sellers' (2011) 86 *Acc Rev* 101, 102. However short sellers face different incentives from analysts because they place their own capital at risk.

devote resources to gathering and analysing information as the basis for their investment decisions.¹⁸

They perform a role similar to analysts and other market professionals who gather information about a company and analyse it, deciding whether a security is undervalued and should be purchased or overvalued and should be sold.¹⁹ Analysts contribute to market efficiency through exploiting any deviations from the fundamental value of a security by arbitrage trading, which will move the price to a new equilibrium.²⁰ Indeed some studies suggest that the contribution of short sellers to market efficiency is greater than that of analysts by providing an important counter-balance through arbitrage trading.²¹ This can be especially important where analysts have the tendency to deemphasise negative information and over-recommend the purchase of particular securities due to private incentives to obtain investment banking business.²² Overly optimistic purchase recommendations could, in some cases, fuel a speculative bubble unless short sellers are able to step in to provide an important counter-balance to the market through arbitrage trading.²³

In summary, the main argument in favour of allowing short selling is that it is an economically beneficial practice, undertaken in the main by sophisticated

¹⁸ Goshen and Parchomovsky (n 7) 723.

¹⁹ John Armour and others, *Principles of Financial Regulation (Draft Version)* (OUP forthcoming 2016) ch 8, 18.

²⁰ *Ibid* 17.

²¹ Drake, Rees and Swanson (n 17) 125; Armour and others (n 19) 18.

²² Powers, Schizer and Shubik (n 4) 241.

²³ Note as well that in the opposite situation, i.e. in a falling rather than a rising market, the concern that short sellers might have a negative impact and amplify price falls does not seem to be borne out in the literature, see further n 30 and text to n 30 below; Jennifer Payne, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 EBOR 413, 420.

information traders, that helps promote market efficiency.²⁴ In line with the theory of efficient capital markets, short selling provides a means by which short sellers who know a security is overvalued can trade on the information, promoting more efficient pricing.²⁵

Short selling also increases market efficiency through enhancing liquidity and trading opportunities. It raises the number of potential sellers in the market, and this enhances liquidity by increasing trading volumes and reducing transaction costs by reducing bid-ask spreads.²⁶ Furthermore short selling contributes to more efficient price discovery: unfavourable price information is likely to adjust quicker in the absence of short sale constraints. As a result if short selling is prohibited, not all information will be fully reflected in stock prices.²⁷ Similarly, imposing restrictions on short selling does not stabilise prices. Such views are generally supported in both theoretical literature and empirical findings.

Theoretical Literature: Effect on Stock Prices

²⁴ Jonathan Macey, Mark Mitchell and Jeffrey Netter, 'Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash' (1988) 74 Cornell L Rev 799, 800. The SEC and the FSA have both endorsed the view that short selling plays an important role in supporting efficient markets, see e.g. FSA, 'Short Selling Discussion Paper 17' (2002) 16; Short Sales, Exchange Act Release No. 34-42,037, 64 Fed. Reg. 57,996 (October 1999) 3.

²⁵ Macey, Mitchell and Netter (n 24) 800. The role of short sellers is also particularly important when considering that there are a large number of long sellers in the market but few contribute to the price formation process as many are optimistic noise traders. In contrast there are fewer short sellers but a higher proportion of them are information traders who help promote market efficiency.

²⁶ FSA, 'Short Selling Discussion Paper 09/1' (2009) 10. The bid-ask spread can be defined as the difference in price between the highest price a buyer is willing to pay for a security and the lowest price for which a seller is willing to sell it.

²⁷ Seraina N. Grunewald, Alexander F. Wagner and Rolf H. Weber, 'Short Selling Regulation after the Financial Crisis: First Principles Revisited' (2011) 7 International Journal of Disclosure and Governance 108, 113.

Miller's seminal paper found that, where investors had differing beliefs, permitting short sales tended to moderate the tendency for riskier stocks to be bid up to higher prices. Investors with negative information could reveal their beliefs through trading, meaning that all information was fully reflected in the price. In contrast, short selling restrictions that prevented investors from revealing their beliefs through trading resulted in an upward bias in stock prices that reflected only the beliefs of the overly optimistic investors.²⁸ A subsequent study by Diamond and Verrecchia found that short sale constraints eliminated some informative trades. Prices were not biased upward where investors took account of short selling restrictions when forming their expectations, but prices became less efficient as the speed of adjustment to private information was reduced, especially to bad news.²⁹ A paper by Bai et al. also demonstrated that short sale constraints could in fact cause prices to drop and volatility to increase. This happened because short sale constraints had a significant impact on informed investors, lowering the informative value of prices.³⁰ Thus, regardless of whether short sale constraints are perceived to have a positive or a negative effect on prices, short sale constraints reduce the informational efficiency of prices so that they no longer reflect all available information.³¹

Liquidity and Hedging

²⁸ Edward M. Miller, 'Risk, Uncertainty, and Divergence of Opinion' (1977) 32 J Fin 1151, 1162.

²⁹ Douglas W. Diamond and Robert E. Verrecchia, 'Constraints on Short-Selling and Asset Price Adjustment to Private Information' (1987) 18 Journal of Financial Economics 277, 302-303.

³⁰ Yang Bai, Eric Chang and Jiang Wang, 'Asset Prices under Short-Sales Constraints' (2006) Working Paper, 31 <http://web.mit.edu/wangj/www/pap/BCW_061112.pdf> accessed 10 December 2012. The prediction that short selling constraints can aggravate a price decline rather than prevent it can also be seen in a model by Hong and Stein, see Harrison Hong and Jeremy C. Stein, 'Differences of Opinion, Short-Sales Constraints, and Market Crashes' (2003) 16 Rev Fin Stud 487, 516. The authors found that unrevealed negative information of investors, who would have engaged in short selling, only emerged when the market began to drop.

³¹ Pedro A. C. Saffi and Kari Sigurdsson, 'Price Efficiency and Short Selling' (2011) 24 Rev Fin Stud 821, 825.

Short selling can also enhance market liquidity by increasing the number of potential sellers in the market; this improves efficiency by raising trading volumes and reducing transaction costs.³² In the absence of short selling restrictions, short sellers will find it easier to trade and so will their trading partners. Indeed, naked short selling in particular can be employed by market makers and other liquidity providers to quickly and efficiently fulfil orders and can provide liquidity when it is otherwise scarce.³³ Short selling also facilitates hedging that reduces investor risk.³⁴ In addition to this indirect benefit, hedgers will also use short selling directly to protect themselves from price declines. Consequently hedging increases liquidity, because reduction of risk enables traders and market makers to take large positions.³⁵

Empirical Evidence: Market Efficiency and Short Selling

Appendix 1 to the thesis provides an overview of the main empirical findings in relation to short selling and market efficiency. Such findings add considerable weight to the argument that short selling contributes to efficient pricing and does not generally support the view that unrestricted short selling can destabilise prices. As Appendix 1 illustrates, the studies differ in terms of methodological choices including the dataset and periods under investigation and it is acknowledged that this makes

³² FSA (n 26) 10. Liquidity can be defined as the ease with which a trade is completed.

³³ Veljko Fotak, Vikas Raman and Pradeep Yadav, 'Naked Short Selling: The Emperor's New Clothes' American Finance Association Denver Meetings Paper (2010), 5 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573163> accessed 19 November 2012. However for an exception to the bulk of the findings see Steven Lecce, Andrew Lepone and Reuben Segara, 'The Impact of Naked Short-Sales on Returns, Volatility and Liquidity: Evidence from the Australian Securities Exchange' (2008) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1253176> accessed 8 February 2013.

³⁴ Macey, Mitchell and Netter (n 24) 811. Hedging can be defined as taking opposite positions in similar assets in order to offset risk.

³⁵ Ibid 812.

comparisons tricky. Nonetheless broadly the findings demonstrate that stock prices are more efficient when short selling is allowed, and that there is little convincing evidence that constraints support prices and prevent price declines.

Among the more recent studies, Saffi and Sigurdsson demonstrated that the ability to short sell increased the informational efficiency of prices and that short sale restrictions generally made markets less efficient.³⁶ Their findings demonstrated that stocks with higher short sale constraints, measured as low lending supply, had lower price efficiency but were not more stable. Further, relaxing short sale constraints was not associated with increasing price instability or the occurrence of extreme negative returns.³⁷

Likewise, a study by Bris et al. used regulatory information on whether short selling was prohibited or practiced in 46 different countries to consider whether short sale restrictions affected the efficiency of the market.³⁸ The authors found evidence that prices were more efficient in countries when investors were allowed to sell short as bad news was more rapidly impounded into prices.³⁹ Short selling facilitated efficient price discovery in countries where short sales were allowed and practiced.⁴⁰

³⁶ Saffi and Sigurdsson (n 31) 822-823. See Appendix 1 for details. Charoenrook and Daouk's empirical evidence also suggests that allowing short selling enhances market quality, see Anchada Charoenrook and Hazem Daouk, 'A Study of Market-Wide Short-Selling Restrictions' Department of Applied Economics and Management Cornell University Working Paper (2009) <http://dyson.cornell.edu/research/researchpdf/wp/2009/Cornell_Dyson_wp0921.pdf> accessed 13 December 2012

³⁷ Saffi and Sigurdsson (n 31) 822, 824. See also Charles M. Jones and Owen A. Lamont, 'Short-Sale Constraints and Stock Returns' (2002) 66 *Journal of Financial Economics* 207, see Appendix 1.

³⁸ Arturo Bris, William N. Goetzmann and Ning Zhu, 'Efficiency and the Bear: Short Sales and Markets around the World' (2007) 62 *J Fin* 1029, 1030. See Appendix 1 for further details.

³⁹ See *ibid*, 1031. In more efficient markets individual stock returns co-move less with the market, and are less correlated with past market returns as information is impounded into the price immediately.

⁴⁰ *Ibid* 1032. See also Ekkehart Boehmer and Juan (Julie) Wu, 'Short Selling and the Price Discovery Process' (2013) 26 *Rev Fin Stud* 287.

Turning to the empirical work exploring the short selling bans imposed during the financial crisis, Appendix 2 summarises the main findings. Again, the parameters of these studies vary with respect to methodological choices, including the jurisdictions considered, the data used, and the precise issues under examination. Likewise, it is also recognised that these studies do not take place in ‘normal’ market conditions. Nonetheless collectively these empirical findings help demonstrate that there is little convincing evidence that short sale constraints support prices and prevent price declines. In fact, the studies investigating the temporary bans suggest that they may have contributed to price declines.

Among the empirical studies, a recent and influential paper by Boehmer et al. examined the US emergency order that temporarily banned most short sales in nearly 1000 financial stocks in September 2008.⁴¹ The authors observed a large price increase for banned securities on its announcement followed by gradual decreases in price during the ban.⁴² It was recognised that the price increase around the ban’s announcement could have been affected by the associated announcement of the Troubled Asset Relief Program (‘TARP’). The authors also found that all but the smallest securities subject to the ban suffered a severe degradation in market quality.⁴³ The authors concluded that ‘given the evidence, it is not at all clear that the SEC

⁴¹ Ekkehart Boehmer, Charles M. Jones and Xiaoyan Zhang, ‘Shackling Short Sellers: The 2008 Shorting Ban’ (2013) 26 *Rev Fin Stud* 1363. See Appendix 2 for further details.

⁴² *Ibid* 1398. TARP was the bank rescue package created by the US government in October 2008.

⁴³ *Ibid* 1364. For further details on this, see Appendix 2.

achieved its unstated goal of artificially raising prices on financial stocks, and it is clear that market quality was severely compromised'.⁴⁴

Closest to Boehmer et al's analysis was a study by Beber and Pagano that explored regulatory interventions imposed around the world in 2008-2009.⁴⁵ They found that temporary short selling bans were responsible for a significant deterioration of market liquidity, that the bans slowed down price discovery, especially where negative news was concerned, and that this was particularly the case during overall market declines, consistent with theoretical predictions and previous empirical findings.⁴⁶ The authors also found that the bans failed to support prices and were not associated with better stock price performance.⁴⁷ Further, in countries other than the US, temporary short selling bans were associated with either no significant change or a decline in stock returns.⁴⁸

In relation to the UK, an independent study by Clifton and Snape examined market liquidity following the FSA's decision to ban temporarily short selling in selected financial and insurance securities in September 2008.⁴⁹ The authors surveyed measures of market liquidity in banned stocks against a control sample of stocks not subject to the ban and found that restricted securities exhibited a significant

⁴⁴ Ibid 1399.

⁴⁵ Alessandro Beber and Marco Pagano, 'Short-Selling Bans around the World: Evidence from the 2007-09 Crisis' (2013) 68 J Fin 343 344. See Appendix 2 for further details.

⁴⁶ Ibid, 375. The authors also found that the negative effects on liquidity were more pronounced for small-cap stocks.

⁴⁷ The possible exception was US stocks due to the confounding effect of the TARPS announcements, see Appendix 2.

⁴⁸ Beber and Pagano 378-379. Note that this was also consistent with the predictions by Bai, Chang and Wang (n 30) and Hong and Stein (n 30).

⁴⁹ Matthew Clifton and Mark Snape, 'The Effect of Short-Selling Restrictions on Liquidity: Evidence from the London Stock Exchange' (2008).

deterioration in liquidity that was not explainable by market wide changes such as increased volatility.⁵⁰

Ultimately, both the theoretical and empirical evidence strongly suggests that stock prices are more efficient and that liquidity is enhanced when short selling is allowed, and there is little convincing evidence that short sale constraints support prices and prevent price declines.

2.2.1.3 Concluding Remarks: Market Efficiency

Financial economists have extensively investigated the effects of short sale constraints on market efficiency and the research has been remarkable for its consistent conclusion that short selling increases market efficiency.⁵¹ The literature generally supports the market efficiency and liquidity benefits of both covered and naked short selling, and broadly speaking does not endorse the view that unrestricted short selling destabilises prices.⁵² The theoretical and empirical findings also suggest that short sale restrictions generally make markets less efficient and do not achieve the desired objective of stabilising prices. Therefore, when we turn in Chapter 4 to examine the restrictions that have now been imposed on short selling, these

⁵⁰ Ibid 2-4, 7. For further details, see Appendix 2. See also Ian Marsh and Norman Niemer, 'The Impact of Short Selling Restrictions' (Independent Analysis, November 2008) who found no strong evidence that short selling restrictions imposed in the UK changed the behaviour of stock returns. See Appendix 2.

⁵¹ Katherine McGavin, 'Short Selling in a Financial Crisis: The Regulation of Short Sales in the United Kingdom and the United States' (2010) 30 Nw J Int'l L & Bus 201, 226.

⁵² For an alternative view see e.g. Franklin Allen and Douglas Gale, 'Arbitrage, Short Sales, and Financial Innovation' (1991) 59 *Econometrica* 1041; Antonio E. Bernardo and Ivo Welch, 'Liquidity and Financial Market Runs' (2004) 119 Q J Econ 135.

constraints will need to be very carefully weighed against the very strong evidence of short selling's benefits discussed here.

2.2.2 Short Selling: Systemic Risk

Turning to consider systemic risk concerns, during periods of market turbulence, the collapse of a firm can have a contagious effect: the downward price pressure can spread and destabilise prices in securities of the same sector or throughout the market. Where financial institutions are also involved, this can have serious implications for the market and the economy if their ability to lend is impaired. During the recent financial crisis, many were swift to blame short sellers for driving down prices and having a contagion effect.⁵³ As already noted, partly due to external pressures, regulators considered that excessive short selling could amplify price falls and that this could lead to disorderly markets and systemic consequences.⁵⁴

Systemic risk is a serious issue and there is much rhetoric about systemic concerns in the Commission Short Selling Proposal (the 'Proposal') and its accompanying Impact Assessment.⁵⁵ As will be considered further in Chapter 3, this particularly reflected the Proposal's gestation in the light of the global financial crisis, and the efforts of regulators to be seen to be taking control of unruly financial

⁵³ David P. McCaffrey, 'Review of the Policy Debate over Short Sale Regulation During the Market Crisis' (2009) 73 Alb L Rev 483, 492. See also FSA (n 26) 12. This 'blame' game is not a new phenomenon: short sellers have often been blamed for previous crashes and declines including the troubles of the East India Company in 1609 and the 1929 Wall Street crash.

⁵⁴ European Commission, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps SEC(2010) 1055, 5. See also IOSCO, 'Regulation of Short Selling, Consultation Report' (March 2009) 5 that stated that its proposed regulatory principles included the reduction of systemic risk.

⁵⁵ See e.g. Short Selling Proposal (n 2) 2-3; Impact Assessment (n 54) 6, 17, 20. The Short Selling Regulation also refers to systemic risk, albeit in a more delicate fashion, Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1 (Reg 236/2012), recitals 1, 7-8

markets.⁵⁶ However, as will be explored in this section, it is not at all evident from a legal and economic perspective that there are such concerns raised by short selling in the context of the serious systemic fears that arose during the 2008 financial crisis.

2.2.2.1 Short Selling and Systemic Risk: Failure of Financial Institutions

It is often acknowledged that defining systemic risk is not simple, and a great deal of confusion exists as to what types of risk are truly systemic.⁵⁷ Although it can be tricky for regulators to agree on its boundaries, systemic risk not confined to the financial sector: the focus should not be on the character of an individual firm but rather on its potential to affect markets. Additionally, although there is no single type of systemic risk, it can be broadly defined as an economic shock whose effects are felt beyond the institution or firm affected, in a way that raises concerns for the financial system as a whole.⁵⁸

During the recent financial crisis, systemic concerns became particularly accentuated following the collapse of Lehmans. Its failure signalled to investors and creditors that there was a likelihood of major losses in their investments in financial sector firms.⁵⁹ Prices fell and markets witnessed major increases in short selling.⁶⁰

⁵⁶ Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 545.

⁵⁷ For a commonly cited working definition of systemic risk see Steven L. Schwarcz, 'Systemic Risk' (2008) 97 *Geo LJ* 193, 204. Schwarcz's definition does not distinguish among types of financial market participant: the focus is on the potential to affect capital markets. The definition also encompasses a localised economic shock that sets in motion failures or losses within the financial system.

⁵⁸ *Ibid* 204.

⁵⁹ Payne (n 23) 416.

⁶⁰ Avgouleas (n 1) 72.

Additionally, as financial institutions were affected, there was a risk of systemic effects. Their collapse could potentially affect the ability of all firms to conduct their business, meaning the negative effects could be felt throughout the market and economy.⁶¹ As regulators took the view that such firms could be vulnerable to short selling strategies, they took emergency measures to temporarily restrict or ban short selling in listed financial sector securities to help stabilise the markets.⁶²

However despite regulators' fears, it is not at all evident that short selling was behind the price falls and resulting systemic effects. Specifically, evidence since 2008 has suggested that short selling was not the main reason behind the drastic price falls. For instance an empirical study by Fotak et al. investigated, amongst other issues, naked short selling surrounding the collapse of Lehmans and others and found that, contrary to media perceptions, naked short sellers were neither behind the drastic price falls nor their collapse.⁶³ The authors observed that naked short selling was generally too low to trigger such declines and even when such activity did become heavy, it was after price declines, not before, and was in response to news in the public domain.⁶⁴

⁶¹ Payne (n 23) 416.

⁶² See FSA (n 26) 12. See also Markus K. Brunnermeier and Martin Oehmke, 'Predatory Short Selling' (2013) 18 *Review of Finance* 2153, 2183, who present a model providing a potential justification for introducing temporary short selling restrictions. However, they acknowledge that the benefits would have to be weighed against the cost of preventing short sellers providing their beneficial role in contributing to market efficiency. They also observe that alternative regulatory measures could include requiring financial institutions to hold more equity, or for financial institutions to issue a type of 'reverse convertible debt' that converts into equity when leverage constraints imposed by creditors bind.

⁶³ Fotak, Raman and Yadav (n 33) 35. See Appendix 2, 'Fotak Part 2'. See also Veljko Fotak, Vikas Raman and Pradeep K. Yadav, 'Fails-to-Deliver, Short Selling, and Market Quality' (2014) 114 *Journal of Financial Economics* 493.

⁶⁴ Fotak, Raman and Yadav 5 (n 33) 27.

Similarly, analysis conducted by the US Office of Economic Analysis was also inconsistent with the notion that extreme negative returns were the result of short selling activity, and its analysis suggested that long, rather than short, sellers accounted for most of the downward price pressure.⁶⁵ Further, many other factors, including rumours, poor company results, a lack of investor confidence, and the media played more of a significant role than short selling activity in the upsurge of volatility and systemic effects.⁶⁶

Additionally, as we considered in section 2.2.1.2 above, the temporary short selling bans imposed during the crisis neither prevented the market's decline nor reduced volatility. For instance in practice the US temporary naked short selling ban failed to slow the price decline, whilst securities subject to the UK short selling ban exhibited a significant deterioration in market liquidity.⁶⁷

Taking this into consideration, it is not evident that short selling destabilises markets leading to systemic concerns, and such sentiments are likely to be more political than legal. Although there were serious systemic effects to be addressed surrounding the financial crisis, short selling was not the main driver behind such effects. Short sellers should not be made 'scapegoats', and it has been suggested that railing against short sellers seems to be shooting the messenger rather than listening to the message.⁶⁸ Rather, the preferable view is that the major falls in the prices of

⁶⁵ E.g. Office of Economic Analysis, 'Analysis of Short Selling Activity During the First Weeks of September 2008' (2008) 2-3. See further Appendix 2. Interestingly, despite these findings, and in contrast to short selling where new regulations have been promptly proposed, no additional long selling regulation has been introduced.

⁶⁶ FSA (n 26) 12; Impact Assessment (n 54) 24.

⁶⁷ Fotak, Raman and Yadav (n 33) 6; Clifton and Snape (n 50) 2.

⁶⁸ Roberta S. Karmel, 'IOSCO's Response to the Financial Crisis' (2012) 37 J Corp L 849, 880.

financial securities and the potential systemic effects were more due to factors such as news about the serious deterioration of the quality of the bank assets, and genuine market panic, amplified by investor herding behaviour,⁶⁹ and less due to increased volumes of short selling.⁷⁰

2.2.2.2 Concluding Remarks: Systemic Risk

It is not apparent that there is a systemic issue raised by short selling. Contrary to popular perception, naked short sellers neither precipitated the collapse of Lehmans and others, nor did they trigger the large share price declines. Notably, when considering the UK and US temporary bans, it is significant that no supporting economic analysis was offered, and it has since been suggested that some of the actual goals of the bans were not so much to stabilise prices as to ‘scare the participants in the market...just as a sheriff in a western town when things are out of control’.⁷¹ This suggests that the real rationale was political rather than legal or economic: a desire by regulators ‘to be seen to be doing something’. This is problematic: political concerns do not provide a sufficient basis from which to introduce short selling constraints when legal and economic arguments exist suggesting that such measures can have negative effects.

2.2.3 Short Selling of Sovereign Debt

⁶⁹ Herding can be described as a type of strategic trade behaviour whereby investors copy the strategies of other market participants.

⁷⁰ Avgouleas (n 1) 74.

⁷¹ Henry T. C. Hu, ‘Efficient Markets and the Law: A Predictable Past and an Uncertain Future’ (2012) 4 Annual Review of Financial Economics 179, 192. See also Andrew Ross Sorkin, *Too Big to Fail* (Penguin 2009), 429. Indeed the US Treasury Secretary was urged to forget whether a ban was likely to be effective in removing pressure on financial stocks. It was also suggested that the actions demonstrated a greater willingness to subordinate market efficiency in favour of other governmental goals.

Although the origins of the Regulation stemmed from the financial crisis and related systemic risk concerns, the advent of the European sovereign debt crisis particularly facilitated its passage and was its final catalyst.⁷² Specifically, the decision to regulate the short selling of sovereign debt (which included introducing restrictions on the purchase of uncovered sovereign CDSs) was motivated by political concerns to stabilise the European sovereign debt market and to protect it from speculation.⁷³

Politicisation is a risk to regulatory rule making, and political decisions can result in potentially error-prone and costly rules.⁷⁴ With respect to short selling, political agendas and sensitivities relating to the European sovereign debt markets ultimately led to the adoption of a distinct (and less onerous) set of restrictions on uncovered short sales in sovereign debt than the rules introduced on short selling securities.⁷⁵ As will be considered further in Chapter 3, there is no regulatory rationale behind this differential treatment: the short selling of sovereign debt is no different from a legal or economic perspective from the short selling of securities, and only political concerns relating to the management of countries' budget deficits justified this differential treatment.⁷⁶

⁷² Oskari Juurikkala, 'Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis' (2012) 9 ECFR 307, 311.

⁷³ Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 CML Rev 1317, 1372. See also Karmel (n 68) 880.

⁷⁴ Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (n 73) 1372-1373.

⁷⁵ For instance the sovereign debt restrictions introduced in the Regulation do not apply where the transaction serves as a hedge to a long position provided that correlation requirements are satisfied. Equally the restrictions can also be temporarily lifted if a country's sovereign debt market is impaired by the restrictions. See Regulation 236/2012, arts 13(2)-(3). See also Moloney, *EU Securities and Financial Markets Regulation* (n 56) 557.

⁷⁶ The Commission in fact acknowledged that the rules had been tailored for sovereign debt due to such concerns. See Commission, 'Short Selling: Technical Standards – Frequently Asked Questions' (2012).

Additionally, it should also be observed that no specific measures were ever introduced on the short selling of sovereign debt in the US as no such crisis materialised there.⁷⁷ Notably, this lack of harmonisation of approaches reflects different jurisdictions responding to distinct political agendas and market conditions in the aftermath the global financial crisis.⁷⁸ Specifically, once a strong political interest existed for a regulatory reaction to the sovereign debt crisis, Europe went its own way.⁷⁹

2.3 Short Selling: Market Manipulation

Regulators stated that a further rationale behind the 2008 temporary bans was the heightened risk of market abuse posed by short selling during periods of extreme market turbulence.⁸⁰ Although short selling can be used in the context of insider dealing to profit from inside information, the particular concern that arises is in relation to short selling being used to manipulate the market.⁸¹ For instance short selling can potentially be used abusively to create misleading signals about the real supply or correct valuation of a security, and it can also be used with scaremongering

⁷⁷ Impact Assessment (n 54) 20. Indeed, more generally the broader international regulatory agenda shifted to focus more on related over-the-counter derivatives reforms than short selling regulation per se.

⁷⁸ Chris Brummer and Rachel Loko, 'The New Politics of Transatlantic Credit Rating Agency Regulation' (2012), 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2179239> accessed 18 January 2012.

⁷⁹ Karmel (n 68) 883.

⁸⁰ See e.g. FSA (n 26) 3.

⁸¹ Insider dealing can broadly be described as using inside information to make a profit or avoid a loss. Market manipulation covers a wide range of behaviour intended to make a profit or avoid a loss, including spreading false rumours to artificially move the price of securities so the manipulator can profit.

tactics to push the price of a security down.⁸² Regulators generally take the view that the risks are greater with naked short selling as they consider that naked short sellers can give false or misleading impressions as to the supply of shares, as they do not have the shares to sell at the time of the sale.⁸³

Market manipulation clearly has a detrimental effect on market efficiency: it interferes with the normal price forming mechanisms and can undermine informational efficiency.⁸⁴ Although this of itself is sufficient reason to justify its regulation, it will be considered whether there is a special case for requiring additional constraints in the context of the market abuse concerns that arise from short selling. Short selling in the context of seasoned equity offerings ('SEOs')⁸⁵ is included in this part as a case study.

This section suggests that existing market abuse regimes should be sufficient to deal with any manipulative behaviour arising.⁸⁶ Although existing rules take the form of 'ex post'⁸⁷ liability rules, market abuse concerns do not merit also introducing additional 'ex ante'⁸⁸ permanent short selling restrictions. Any such ex ante rules would also restrict legitimate short selling activity that, as we have already observed, provides considerable benefits to markets. Further, introducing ex ante shorting restrictions to constrain its possible abusive exploitation would also most likely create

⁸² FSA (n 26) 11. See also Itay Goldstein and Alexander Guembel, 'Manipulation and the Allocational Role of Prices' (2008) 75 Rev Econ Stud 133.

⁸³ FSA (n 26) 11.

⁸⁴ Armour and others (n 19) ch 8, 10.

⁸⁵ SEOs include but are not limited to rights issues.

⁸⁶ The possibility of also requiring private notification requirements to regulators in circumstances where there is a high risk of market abuse occurring will be explored further in Chapter 5.

⁸⁷ Ex post rules apply 'after the fact'.

⁸⁸ Ex ante rules apply 'before the event'.

greater costs than benefits.⁸⁹ Instead, there should be better enforcement of existing market manipulation rules and this should be sufficient to provide an effective deterrent and help reduce the risk of any abusive behaviour occurring. It is also submitted that naked short selling is not a special case meriting the introduction of a permanent naked short selling prohibition. Instead, imposing strict settlement rules with large penalties for failure to deliver should help deter and reduce the risk of any such abusive behaviour occurring.⁹⁰

2.3.1 Short Selling and Market Manipulation

Exactly what behaviour constitutes market manipulation varies between jurisdictions and it is often acknowledged that defining the precise ambit of the rules is not straightforward.⁹¹ However, one clear example involves speculators short selling shares, spreading false rumours about a firm, and then purchasing the shares once the price has dropped.⁹² Turning to SEOs, firms undertaking SEOs may be particularly vulnerable to short selling's negative effects. For example on a rights issue short sellers could try to push the share price in the market below the rights issue price in order to profit from their strategy and boost the supply of shares available from the underwriters, improving their ability to close out their position.⁹³

Empirical Studies

⁸⁹ Grunewald, Wagner and Weber (n 27) 116.

⁹⁰ For a discussion of settlement concerns see section 2.4.

⁹¹ Armour and others (n 19) ch 8, 11. See also IOSCO (n 54) 23.

⁹² Macey, Mitchell and Netter (n 24) 800.

⁹³ FSA (n 26) 12.

Appendix 3 summarises the main empirical findings with respect to short selling and market manipulation. The studies again vary in terms of methodological choices and the findings are also relatively mixed, making comparisons tricky. Nonetheless, broadly the studies suggest that there is only limited evidence as to manipulative short selling behaviour and that imposing short selling constraints can also result in adverse consequences.

First, more generally and in the context of its wider study on naked short selling, Fotak et al. tested for the impact of manipulative naked short selling during the financial crisis and compared it to pre-crisis periods. In particular the authors found no increase in such behaviour from the first half of 2007 to the 2008 financial crisis period and that such behaviour was also significantly lower than it was in 2004.⁹⁴

Turning specifically to SEOs, out of the more recent studies, a paper by Kim and Shin examined the adoption of short sale constraints in the form of Rule 10b-21 and observed significant SEO discounts once the rule came into effect.⁹⁵ The authors provided evidence that *ex ante* uncertainty was related to SEO discounts and concluded that Rule 10b-21 had reduced the informativeness of SEO prices and, by increasing levels of uncertainty, this in turn had caused greater discounts.⁹⁶

⁹⁴ Fotak, Raman and Yadav (n 33) 34; see also Fotak, Raman and Yadav (n 63) 515. For further details see Appendix 3. See also Boehmer and Wu (n 40); Ekkehart Boehmer, Charles M. Jones and Xiaoyan Zhang, 'Which Shorts Are Informed?' (2008) 63 J Fin 491.

⁹⁵ Kenneth A. Kim and Hyun-Han Shin, 'The Puzzling Increase in the Underpricing of Seasoned Equity Offerings' (2004) 39 Financial Review 343, 345. See Appendix 3 on the details of Rule 10b-21.

⁹⁶ Ibid 363. They also distinguished their work from a previous study by Safieddine and Wilhelm, particularly due to Safieddine's use of less accurate data in conjunction with related concerns as to sample selection bias, see Assem Safieddine and William J. Wilhelm, 'An Empirical Investigation of Short-Selling Activity Prior to Seasoned Equity Offerings' (1996) 51 J Fin 729 and Appendix 3.

However, a study by Henry and Koski examined Rule 105 (which relaxed Rule 10b-21) and found that around issue dates higher levels of pre-issue short selling was significantly linked to larger issue discounts in traditional SEOs.⁹⁷ The authors also found that SEC Rule 105 constrained some, but not all, manipulative trading.⁹⁸ A 2013 paper by Autore and Gehy also examined a recent amendment that tightened Rule 105 and found that this could lead to unintended adverse consequences for fundraisings conducted at short notice.⁹⁹ Finally, a recent working paper by Jones et al, found no evidence that short sellers pushed share prices down during rights issues, and that the modest negative returns during rights issues were not due to manipulative short selling.¹⁰⁰

Ultimately, although the findings vary, there is only limited evidence of manipulative behaviour and it is evident that the introduction of constraints can also result in negative consequences. Further, in the specific context of SEOs, it is also clear that factors unrelated to short sales may also affect the offer price stability and its success, including the presence of firm commitments from strategic investors.¹⁰¹ Hence imposing ex ante restrictions on short selling would likely result in a negative impact on pricing efficiency and liquidity but would do nothing to tackle issues that

⁹⁷ Tyler Henry and Jennifer Koski, 'Short Selling around Seasoned Equity Offerings' (2010) 23 *Rev Fin Stud* 4389, 4390. See Appendix 3 for further details.

⁹⁸ *Ibid* 4390.

⁹⁹ Don M. Autore and Dominique Gehy, 'Changing the Rules Again: Short Selling in Connection with Public Equity Offers' (2013) 37 *Journal of Banking & Finance* 1974. See Appendix 3 for further details.

¹⁰⁰ Charles Jones, Adam Reed and William Waller, 'Revealing Shorts: An Examination of Large Short Position Disclosures' (AFA 2013 San Diego Working Paper). See further details, Appendix 3.

¹⁰¹ Emiliós Avgouleas, 'Short-Sales Regulation in Seasoned Equity Offerings: What Are the Issues?' in Dan Prentice and Arad Reiser (eds), *Corporate Finance in the UK and EU* (OUP 2011) 130.

are unrelated to short sales and may also be more important factors than short selling in dictating offer-price stability.¹⁰²

Are Additional Short Selling Constraints Required?

Although it can be used abusively, short selling is not abusive per se,¹⁰³ and market abuse concerns do not justify introducing permanent short selling constraints, whether on naked or all short sales that would interfere with the beneficial effects of short selling observed at section 2.2.1.2 above. Introducing restrictions to try and protect against potentially manipulative behaviour would also likely result in higher costs than benefits. Equally, manipulative short selling practices, such as naked short sellers abusively flooding the market with phantom shares, are likely to be already illegal under existing market manipulation regulation.¹⁰⁴ Thus, although regulation of market manipulation is clearly necessary, the EU and US regulators already have considerable weapons in place that should be used more effectively to combat this problem rather than introducing constraints on short sales.¹⁰⁵

This is also particularly the case when considering that issues of manipulation also arise for long positions: for example an investor could purchase a large block of shares and then profit if this induces unsophisticated investors to buy at higher prices.¹⁰⁶ Indeed short selling may be an effective market tool here in battling market

¹⁰² Ibid 130-131.

¹⁰³ IOSCO (n 54) 23.

¹⁰⁴ Grunewald, Wagner and Weber (n 27) 116.

¹⁰⁵ E.g. measures in the UK include administrative and criminal sanctions for market manipulation in sections 123 and 397 Financial Services and Markets Act 2000 respectively. See Avgouleas (n 1) 95-96.

¹⁰⁶ Powers, Schizer and Shubik (n 4) 246.

manipulations that push the price upwards.¹⁰⁷ Consequently the correct regulatory response is to target all manipulative trading without singling out short sales.¹⁰⁸

2.3.1.1 Concluding Remarks: Market Manipulation

Market manipulation requires regulation as it undermines market efficiency. However both the EU and the US have comprehensive market manipulation legislation in place that should be sufficient to combat any risk of market abuse arising from either covered or naked short selling. Indeed it has been suggested that the failure of regulators to prevent abuses occurring reflects a failure of enforcement rather than bad underlying policy.¹⁰⁹ Short selling is not intrinsically abusive and, given that long positions raise similar issues, the correct response is to target all manipulative behaviour. There is also nothing to suggest that additional ex ante restrictions are necessary or desirable to constrain naked short selling constraints in this context. This is particularly the case if strict settlement rules are also in place.

2.4 Short Selling: Settlement Risk

Turning to then discuss settlement risk, this problem arises in the main due to the need for settlement periods: given the nature of securities, some type of settlement period is necessary as buyers and sellers are not physically present in the market to

¹⁰⁷ Avgouleas (n 1) 96.

¹⁰⁸ Powers, Schizer and Shubik (n 4) 246. Crucially, existing market abuse measures do not affect short selling's important market efficiency and liquidity benefits, see further Payne (n 23) 417.

¹⁰⁹ McGavin (n 51) 201-202.

exchange cash and securities.¹¹⁰ Turning specifically to short selling, this can raise concerns in relation to settlement: if short sellers fail to deliver the shares that they have sold, this can cause settlement disruption.¹¹¹

Regulators consider that naked short selling in particular can give rise to the risk that a seller will be unable to deliver the securities to the buyer and that this can impair the orderly functioning of markets.¹¹² Settlement default may also occur where the seller has no incentive to settle because the market has gone up, or if a security has become illiquid and the short seller is unable to find securities to buy to close out the transaction.¹¹³

Settlement failure is a serious issue: it has the potential to cause disruption to the orderly operation of the market in the securities concerned.¹¹⁴ However it is not necessary to ban naked short selling in order to tackle this concern. As previously observed, naked short selling without any intention or plan to settle the transaction constitutes market abuse;¹¹⁵ and tightening existing settlement measures would adequately address settlement concerns. The precise methods that could be used to this end will be elaborated on further in Chapter 4, but in particular the imposition of strict settlement periods, and the mandating of heavy penalties for failures to settle

¹¹⁰ Armour and others (n 19) ch 8, 25.

¹¹¹ FSA (n 26) 18. However see Fotak, Raman and Yadav (n 63) who find no evidence that fails to deliver caused price distortions or the failure of financial firms during the financial crisis.

¹¹² FSA (n 26) 13. For example it can be difficult for buyers to exercise voting rights over shares or to meet obligations in relation to an onward chain of transactions. See Avgouleas (n 1) 92.

¹¹³ FSA (n 26) 7.

¹¹⁴ Armour and others (n 19) ch 8, 25.

¹¹⁵ FSA (n 26) 13.

would reduce or eliminate any incentives not to settle.¹¹⁶ Ultimately, non-delivery in the context of short sales may not be as big an issue as popularly believed.¹¹⁷

2.5 Does Naked Short Selling Pose Greater Concerns?

In popular sentiment the concerns we have examined with respect to short selling in this Chapter particularly manifest themselves in relation to naked short selling because it can be conducted more aggressively than conventional short selling.¹¹⁸ Consequently, and as we will observe in Chapter 4, regulators often impose a distinct, and more onerous, regime for naked short sales than for covered short sales. However, despite such received wisdom, naked short selling need not be distinguished from covered short selling in this regard.¹¹⁹

First, although greater concerns can arise as to settlement failure with regards to naked short selling, clearing agencies generally have regimes for intervening if settlement does not occur to resolve any fails to deliver.¹²⁰ Next, we have already observed that excessive naked short selling, whereby naked short sellers flood the market with phantom shares with the intention of driving down prices in an abusive fashion, is a manipulative act, already illegal in most jurisdictions.¹²¹

¹¹⁶ Avgouleas (n 1) 92.

¹¹⁷ Impact Assessment (n 54) 48; Grunewald, Wagner and Weber (n 27) 117; Payne (n 23) 418.

¹¹⁸ Grunewald, Wagner and Weber (n 27) 117. In this regard see James Christian, Robert Shapiro and John-Paul Whalen, 'Naked Short Selling: How Exposed Are Investors' (2006) 43 Hous L Rev 1033.

¹¹⁹ See e.g. Christopher L. Culp and J. B. Heaton, 'The Economics of Naked Short Selling' (2008) 31 Regulation 46, 50.

¹²⁰ See also Chapter 4, section 4.2.4.

¹²¹ Grunewald, Wagner and Weber (n 27) 117; Payne (n 23) 418. For a discussion of market manipulation concerns see section 2.3.

Turning to the benefits of naked short selling, an empirical study by Fotak et al. examined its benefits on market quality and found that an increase in naked short selling led to significantly smaller pricing errors. They also focused on a sample of the most naked shorted securities and even then found a positive impact on market quality.¹²² The authors also observed that the positive impact in reducing the mispricing of overpriced securities applied equally to both conventional and naked short selling. In addition, Fotak et al. also examined the market impact of the US ban on naked short selling of select financial institutions in July 2008 and observed that it hampered price discovery and reduced liquidity.¹²³

Ultimately, naked short selling does not lend itself to any stronger justification for regulation: it is not a special case compared with conventional short selling in terms of economic implications.¹²⁴ Additionally, prohibiting naked short selling would also have the detrimental effect of reducing liquidity.

2.6 Conclusion

This Chapter has explored the various grounds put forward for regulating short selling to consider their validity from a legal and economic perspective. Contrary to the view that short selling destabilises security prices, both covered and naked short selling promote market efficiency and neither causes systemic effects. Further, evidence from

¹²² Fotak, Raman and Yadav (n 33) 35; Fotak, Raman and Yadav (n 63) 515. See also Appendix 1.

¹²³ Fotak, Raman and Yadav (n 33) 6. See Appendix 2.

¹²⁴ Grunewald, Wagner and Weber (n 27) 118. See also Culp and Heaton (n 119) who elaborate on the 'near-economic equivalence' between conventional and naked short selling and also suggest that naked short selling creates desirable competition in the securities lending market by enabling the buyer to be able to compete in the market for securities lending.

the 2008 financial crisis suggests that temporary short selling bans do not stabilise prices and can in fact contribute to price declines. There is also no legal or economic justification to treating the short selling of sovereign debt any differently from the short selling of securities.

In the context of market abuse concerns, although short selling can be used for this purpose, this does not make it abusive per se, justifying ex ante constraints on either naked or all short sales, and there are already comprehensive market manipulation regimes that could be used more actively to prevent or tackle any manipulative behaviour occurring. Finally, although settlement risk is a concern, particularly in relation to naked short sales, this does not merit a naked short selling ban. Other, more general measures, such as tightening existing settlement periods, would mitigate this risk.

Although regulators tend to focus particularly on the need to regulate naked short selling, it is not a special case. There are not essentially different arguments for its regulation, just the same arguments ‘writ large’. Naked short selling’s benefits are clear: it contributes to overall market efficiency and naked short sellers can be important providers of liquidity, particularly when it is otherwise scarce. As already observed, abusive naked short selling already constitutes manipulative behaviour, and, the need to combat settlement concerns can be addressed without imposing a naked short selling ban.

Based on the preceding analysis, it is suggested that the recent push to regulate short and not long selling has arisen not due to the existence of clear legal or economic

justifications, but more from external pressure from politicians, the public, and the press following the financial crisis, including the desire by regulators to demonstrate they are combating unruly market forces.¹²⁵ As already highlighted, the benefits of market efficiency are far more intricate and long term in nature than any such perceived short-term benefits.¹²⁶

With this analysis in mind, we will now move into Chapter 3, and start to examine the market conditions and the prevailing political environment that ultimately led to the adoption of the European short selling rules.

¹²⁵ Hu (n 71) 192. See also Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (n 73) 1372-1373.

¹²⁶ Hu (n 71) 192.

Chapter 3: The Politicisation of the European Short Selling Regulation?

3.1 Introduction

As we observed in Chapter 1, the politicisation of regulation has particularly increased since the financial crisis meaning it is ever more likely that unnecessary and costly rules are imposed on market participants.¹ This Chapter analyses the political expediency behind the 2008 temporary short selling bans, examines the US response to short selling regulation in the light of the crisis, and then turns to particularly focus on the political drivers behind the European short selling rules. Specifically the Chapter considers the highly politicised environment and the febrile negotiations that took place both between and within the European institutions that ultimately determined the shape of the final rules.

Although as discussed in Chapters 1 and 2, the Regulation's origins derived from the financial crisis and related concerns with respect to systemic effects, the Regulation's main motivation was the European sovereign debt² crisis, which surfaced particularly in 2010, when the Greek government, amongst others, began to show signs of financial collapse. Specifically, as the Greek situation worsened, short

¹ Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 CML Rev 1317, 1372-1373. See also Oskari Juurikkala, 'Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis' (2012) 9 ECFR 307 (n 5) 311.

² Sovereign debt can be defined as the amount of money that a country's government has borrowed, typically issued as bonds in a strong currency widely used in international trade.

sales and CDSs³ on Greek sovereign debt increased. Certain Member States blamed speculators taking these positions for Greece's financial problems, particularly those purchasing CDSs on Greek sovereign debt.⁴

Due to these allegations, the Commission announced a legislative initiative on short selling, conducted a swift consultation, and produced a proposal in autumn 2010. The subsequent negotiations were protracted and messy, and involved considerable political wrangling and power struggles. Eventually the final text reflected the European Parliament's (the 'Parliament') persistent demands to impose an effective ban on purchasing 'uncovered' (or 'naked') sovereign CDSs. Further, the Regulation contained one set of restrictions on the naked short selling of shares; and another, lighter set of constraints on the naked short selling of sovereign debt.

Although the Parliament hailed the Regulation's passage as a victory over speculating on a country's default,⁵ this was a myopic view that illustrated the politicisation of the process prevailing over economics. Likewise, there was no legal or economic justification behind the differential approach to the restrictions on the short selling of shares and sovereign debt. Only political sensitivities and concerns with respect to the potential damage to countries' sovereign debt markets explained the shape to the final rules.

³ A CDS is a type of credit derivative: a contract designed to lay off credit risk in relation to loans, debt securities, other assets, or a particular entity or country. The CDS purchaser is obliged to make specified fee payments to the seller. If a credit event occurs, the seller will be obliged to make a payment to the buyer. A naked or uncovered sovereign CDS referencing sovereign debt means the buyer purchases the CDS without having an underlying interest in the government debt.

⁴ Robert S. Bloink, 'Does the Dodd-Frank Wall Street Reform Act Rein in Credit Default Swaps? An EU Comparative Analysis' (2010) 89 *Neb L Rev* 587, 598, 591.

⁵ Juurikkala (n 1) 308; European Parliament, *Parliament Seals Ban on Sovereign Debt Speculation and Short Selling Limitations* (2011).

Ultimately the Regulation's introduction illustrated that it was far easier for politicians to pin the blame on speculators, a vague group never clearly defined, than to deal directly with the real problems facing the EU economy.⁶ European politicians simply found in short sellers the ideal scapegoats to deflect from their own failings and to justify the drama of the recent financial turmoil:⁷ a classic case of blaming the messenger.⁸

3.2 Overview: Political Economy

Democracy is said to reflect the will of the voters, however although the public cares about some issues much of the time, there are certain issues that receive little attention at all, and political scientists term such issues as having 'low political salience'.⁹ For example, while issues such as unemployment levels, or the rate of immigration may be highly salient to voters, they may be indifferent at best to whether the financial services industry should be reformed. Indeed, during normal times, questions of financial regulation tend to have low political salience with the public, and politicians recognise they are unlikely to be re-elected trying to capture voters' interest on such issues. The political disinterest stems especially from financial regulation's inherent

⁶ Raoul Ruparel, *Trading Rules Driven by Political Agenda* (7 April 2011).

⁷ Thomas del Marmol, 'Short Selling: Need or Fear? Impact on Financial Markets and Implications for Regulation' 2011, 89 <http://www.professionsfinancieres.com/docs/2012102306_174_vn_m_short-selling.-need-or-fear.pdf> accessed 20 June 2013.

⁸ Clas Wihlborg, Thomas D. Willett and Zhang Nan, 'The Euro Debt Crisis' (2010) 11 *World Economics* 51, 55.

⁹ Pepper D. Culpepper, *Quiet Politics and Business Power* (Cambridge University Press 2011) 4.

complexity and technicalities: ‘few care as passionately about systemic risk as they care about the environment’.¹⁰

Notably, political disinterest gives rise to what has been termed ‘quiet politics’, whereby highly organised interest groups lobby the legislature and dominate the policy process in areas shielded from the public view.¹¹ Particularly in the context of financial regulation, as the financial services industry is organised, powerful, and has the incentive to maintain a strong lobbying presence, it can wield a disproportionate influence over policy.¹² Consequently, during periods of economic growth and booms, these influences mean that existing regulation will be watered down,¹³ and this is the opposite of what is desirable.¹⁴

However, political salience is not always static, and a crisis can lead to a shift in the public mood. Mobilisation efforts of political entrepreneurs can also be crucial, with politicians exploiting public discontent to ensure them subsequent electoral

¹⁰ John Coffee, ‘The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated’ (2012) 97 Cornell L Rev 1019, 1029. See also Viral V. Acharya, ‘Governments as Shadow Banks: The Looming Threat to Financial Stability’ (2012) 90 Tex L Rev 1745. Acharya suggests that the problem is not so much political apathy as short-termism by governments who are in pursuit of short run popularity, even at the expense of the future cost of financial instability.

¹¹ Culpepper (n 9) 4.

¹² Coffee (n 10) 1021. For example the financial industry has both money and expertise. Their greater knowledge in a complex field means it can be particularly difficult for politicians to challenge their expertise, and the low political salience of the issues at stake can also lower their incentives to invest in redressing the balance, see further Culpepper (n 9) 9.

¹³ An example of such de-regulation during a boom is the repeal of the Glass-Steagall Act in 1999. Glass-Steagall had separated investment and commercial banking in the USA.

¹⁴ Financial regulation should be counter-cyclical, not pro-cyclical: there should be more regulation during periods of economic growth and less following a crisis.

success.¹⁵ As public concern rises, politicians start to listen.¹⁶ This then creates a short window to introduce legislation that may otherwise never be passed.¹⁷

Considering financial crises, as much of the public will suffer negative consequences, they will then be passionate for change. Thus, during the short window when such issues have high political salience, there is a powerful imperative for politicians to be ‘seen to be doing something’. Politicians tend to react and pass what are often ‘knee-jerk’ reforms, with policies castigating financial institutions proving particularly popular with the public.¹⁸ Clearly, such a response will not necessarily fit the problem, and regulation following a crash tends to be poorly designed.¹⁹ Indeed, it is frequently suggested that the inevitable regulatory backlash following a financial crisis provides an opportunity to push through reforms that have little true connection to the crisis itself.²⁰

¹⁵ See e.g. Roberta Romano, ‘The Sarbanes-Oxley Act and the Making of Quack Corporate Governance’ (2005) 114 *The Yale Law Journal* 1521, 1524. See also Culpepper (n 9) 6. An example of a political figure playing such an entrepreneurial role includes the former New York Attorney General, Eliot Spitzer, who became New York Governor after gaining recognition for actively pursuing corporations implicated in various scandals.

¹⁶ The media also plays a central role in bringing issues to the public’s attention and is also a way for politicians to infer salience, see e.g. Rosa Prince, ‘Public Anger Growing at ‘Irresponsible’ Banks’ *The Telegraph* (London, 19 January 2009) accessed 24 July 2013. See also Culpepper (n 9) 7-8.

¹⁷ For instance, following the global problems triggered by Enron and WorldCom’s accounting scandals, the US adopted the Sarbanes-Oxley Act (‘SOX’) in 2002. Similarly in the UK, the Financial Markets and Services Act 2000 was adopted in response to various financial flaws arising in the late 1990s. See, Peter Yeoh, ‘Hedge Funds: From Privileged Child to Locust and Now Bogeyman?’ (2012) 33 *Company Lawyer* 42. Equally in the EU, following scandals including Parmalat, that was dubbed ‘Europe’s Enron’, the post-Parmalat landscape included the adoption of the Markets in Financial Instruments Directive 2004/39 (‘MiFID’).

¹⁸ For example in the US, SOX created new criminal penalties and enhanced existing penalties, see Coffee (n 10) 1021.

¹⁹ Romano discusses the disconnection between the source of Enron’s problems and the substantive corporate governance provisions subsequently enacted by SOX, see further Romano (n 15). For a critical response to the worldwide view favoured by Romano and others, see e.g. Coffee (n 10).

²⁰ Eilís Ferran, ‘After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU’ (2011) 12 *EBOR* 379, 379.

Both the general push to regulate short selling following the financial crisis, and the specific enactment of the Regulation reflect this broad pattern. In particular, as will be demonstrated, the Regulation was not only due to politicians' and regulators' desire to act in the face of public discontent, but was also the consequence of domestic political agendas in particular Member States. Hot on the heels of the financial crisis, the sovereign debt crisis led to political entrepreneurs attempting to make gains on their home turf, aiming to ensure political survival through blaming short sellers for the crisis. This however has only led to an error-prone law.

3.3 The Financial Crisis

The main causes of the global financial crisis are now well known,²¹ and during the crisis competent authorities adopted emergency measures worldwide restricting or banning short selling. This section explores this international backdrop, starting with a consideration of the political justifications behind the imposition of the temporary short selling bans. This international picture is particularly relevant given the subsequent lack of harmonisation between the EU's and US's approach to regulating short selling: different jurisdictions responding to varying political realities.²²

3.3.1 The Political Expediency of the Short Selling Bans

Following the collapse of Lehmans, the US and the UK imposed temporary short selling bans, and many other countries swiftly followed their example. Despite the

²¹ Moloney (n 1) 1318. See e.g. FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009). For a concise summary see also Moloney (n 1) 1318-1319.

²² Chris Brummer and Rachel Loko, 'The New Politics of Transatlantic Credit Rating Agency Regulation' (2012), 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2179239> accessed 18 January 2012.

paucity of economic evidence supporting the imposition of the bans, regulators maintained they were concerned short selling could amplify price falls, and that this could lead to disorderly markets and systemic consequences.²³ However as observed in Chapter 2, this does not stand up to scrutiny: short selling was not predominantly behind the major price falls in 2008, and the bans neither prevented further price declines nor reduced volatility.²⁴

Although from a legal and economic standpoint imposing the bans was questionable, politically, the bans made sense. During the crisis, regulators came under extraordinary pressure from all quarters to introduce short selling bans. The press pursued a constant vendetta against short sellers, and many chief executive officers ('CEOs') were obsessed with blaming the short sellers for their problems, rather than admitting their own failings. For instance in the run-up to the collapse of Lehmans, its CEO, Dick Fuld, complained loudly to the SEC and the US Treasury that Lehmans was a 'victim of the shorts'.²⁵ Likewise Morgan Stanley's CEO also believed short sellers were nefariously driving their stock down, and spoke with the SEC, the New York Attorney General, and the Treasury, about instigating a short selling ban.²⁶ Indeed the US Treasury Secretary was subsequently encouraged by Wall Street to forget whether or not bans would even be effective in reducing or removing pressure on financial stocks.²⁷

²³ European Commission, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps SEC(2010) 1055, 5.

²⁴ See Chapter 2 section 2.2.2.

²⁵ Bill Saporito, 'Are Short Sellers to Blame for the Financial Crisis?' *TIME Magazine* (18 September 2008)

²⁶ Andrew Ross Sorkin, *Too Big to Fail* (Penguin 2009), 424-426.

²⁷ *Ibid* 429. It has also been suggested that the actions demonstrated a greater willingness to subordinate market efficiency in favour of other governmental goals, see Henry T. C. Hu, 'Efficient

Further, it was also clear that doing nothing was not an option for the regulators. Although they could do little, if anything, to change the course of events, they could not be seen to stand idle.²⁸ The sense of urgency accompanying the crisis required everyone to be seen to be acting to prevent it, and it would have been embarrassing for regulators to admit there was nothing they could do to avoid a meltdown.²⁹ This would also have raised questions as to what purpose they served during normal times, and could have led to a subsequent negative political spiral for them.³⁰

Taking this into account, regulators around the world had to act, and banning short selling made political sense.³¹ Although regulators had little experience with trading bans,³² they were easy to sell to the public as an assertive course of action, plus crucially, the bans were only temporary.³³ Thus, by introducing the bans, however crude and ineffective they turned out to be in practice, regulators solved the ‘trade-off between political expediency and the need to preserve well functioning markets’.³⁴

Markets and the Law: A Predictable Past and an Uncertain Future’ (2012) 4 Annual Review of Financial Economics 179, 192. See also Chapter 2, section 2.2.2.

²⁸ Luca Enriques, ‘Regulators’ Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator’s View’ (2009) 30 University of Pennsylvania Journal of International Law 1147, 1148.

²⁹ Ibid 1148.

³⁰ Ibid 1148.

³¹ Ibid 1149. For instance following the US and UK bans, regulators across Europe took similar action, as did Australia.

³² Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 541; Henry T. C. Hu, ‘Too Complex to Depict? Innovation, “Pure Information,” and the SEC Disclosure Paradigm’ (2012) 90 Tex L Rev 1601, 1687-1701. For instance the last time short selling was banned in the US was in the 1930s before the SEC was created.

³³ Enriques (n 28) 1149.

³⁴ Ibid 1149; Moloney, *EU Securities and Financial Markets Regulation* (n 32) 541.

3.3.2 IOSCO: Principles for Short Selling Regulation

Despite the flurry of trading bans and the related concerns as to the lack of a global harmonised response, short selling regulation did not then become a top priority at the Washington G20³⁵ summit. Indeed its reform programme contained no specific mention of short selling and focused on issues including implementing policies to exercise strong oversight over credit rating agencies, and to reduce systemic risk in OTC derivatives transactions.³⁶ Separately however, IOSCO subsequently responded in a relatively measured, albeit light touch, way, in a 2009 report where it formulated four high-level principles for short selling regulation.³⁷

IOSCO considered that short selling played an important role in the market and that this should be protected in any regulation.³⁸ It stated that the primary role of regulation should be to reduce the potentially destabilising effect short selling could cause when used in an abusive manner, without impacting unduly on securities lending, hedging and other types of transaction critical to capital formation and to

³⁵ G20, the Group of Twenty, consists of Twenty Finance Ministers and Central Bank Governors from 19 countries worldwide plus the EU. It is the leading forum for international cooperation on the most important issues of the global economic and financial agenda. The first meeting was the Washington Summit in November 2008.

³⁶ G20 Declaration, Washington Summit on Financial Markets and the World Economy, Declaration (15 November 2008). This was also the case at subsequent G20 meetings in 2009 in London and Pittsburgh, see London Summit, Leaders' Statement (2 April 2009); Leaders' Statement: The Pittsburgh Summit (24-25 September 2009).

³⁷ Roberta S. Karmel, 'IOSCO's Response to the Financial Crisis' (2012) 37 J Corp L 849, 876. Its report was preceded by a Consultation Paper, see IOSCO, 'Regulation of Short Selling, Consultation Report' (March 2009).

³⁸ IOSCO, 'Regulation of Short Selling, Final Report' (June 2009) (n 37) 5; Emiliios Avgouleas, 'The Vexed Issue of Short Sales Regulation When Prohibition Is Inefficient and Disclosure Insufficient?' in Kern Alexander and Niamh Moloney (eds), *Law Reform and Financial Markets* (Edward Elgar 2011) 97.

reducing volatility.³⁹ It also noted that short selling regulation varied substantially between its members and that, in light of the recent experiences during the financial crisis, there was merit in having a more common approach to short selling regulation.⁴⁰ It proposed appropriate disclosure of short selling trades, strict settlement rules of failed trades to discourage abusive behaviour, and an effective compliance and enforcement system. Further it proposed that regulation should allow for appropriate exceptions for certain types of transactions for efficient market functioning and development'.⁴¹

Ultimately, there was considerable disagreement between countries as to the necessity for, and the appropriate tools, for regulation and IOSCO's recommendations were the subject of much compromise.⁴² Consequently its principles were too light touch and high level to lay the groundwork for any subsequent regulation.⁴³ Nevertheless, IOSCO did seek to limit any pressure post-crisis to, for example, impose permanent short selling bans, or to re-introduce an 'uptick rule'.⁴⁴ IOSCO also recognised the need for supranational harmonisation of short selling rules: a serious issue in increasingly globalised markets. Further, IOSCO's relatively cautious approach was also in contrast to its recommendations in many other areas following

³⁹ IOSCO (n 38) 5.

⁴⁰ Ibid 6. IOSCO considered this would help simplify the compliance process and reduce the risk of regulatory arbitrage.

⁴¹ Ibid 18.

⁴² See Jennifer Payne, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 EBOR 413, 428-9.

⁴³ Ibid 428-9.

⁴⁴ Karmel (n 37) 880. Put simply, an uptick rule required that before a security could be sold short the price had to rise. The uptick rule will be discussed further in Chapter 4.

the crisis where it proposed considerably increasing the level of regulation.⁴⁵

3.3.3 US Response

Turning to the US, although the precise nuts and bolts of its short selling rules will be explored in subsequent Chapters, no regulation on the short selling of sovereign debt was ever introduced in the US following the crisis. As we observed in Chapter 2, no such crisis ever materialised in the US triggering a regulatory response as it did in Europe. Indeed, as this Chapter demonstrates, varying political realities and pressures led to distinct approaches being taken to short selling regulation on both sides of the Atlantic.

Specifically, as we have already observed, short selling regulation was not a top priority on the international post-crisis reform agenda and the US subsequently introduced various short selling reforms on a more piecemeal basis.⁴⁶ For instance, in October 2008, the SEC introduced a ‘naked short selling antifraud rule’.⁴⁷ Despite its ‘populist’ name, this rule neither bolstered, nor extended, the existing rules on naked short selling or market manipulation.⁴⁸ With this in mind, this rule’s origin was likely more political than legal, motivated by the financial crisis that propelled the

⁴⁵ Ibid 880. This included for example the increased regulation of hedge funds, see e.g. Ferran (n 20) 392.

⁴⁶ For instance some short selling reforms were contained in the Dodd-Frank legislation introduced in the US in 2010 as a response to the crisis. These reforms focused on increasing the disclosure of short selling transactions, see e.g. section 417(a) and 929X Dodd Frank. See also Chapter 5.

⁴⁷ Rule 10b-21 Securities and Exchange Act 1934 (‘Exchange Act’).

⁴⁸ Seraina N. Grunewald, Alexander F. Wagner and Rolf H. Weber, ‘Short Selling Regulation after the Financial Crisis: First Principles Revisited’ (2011) 7 *International Journal of Disclosure and Governance* 108, 120.

SEC to react to the public aversion against naked short selling.⁴⁹

In addition, considerable political pressure was also placed on the SEC to reinstate the uptick rule that it had repealed in 2007 following a careful and measured process. This included the threat of Congressional legislative action, plus strong pressure from the US administration.⁵⁰ Such political demands stemmed in particular from damage caused to the SEC's reputation in the light of the crisis. Specifically, the SEC had been criticised for its supervision of the investment banks, most of which had suffered financial turmoil, and it had also lost credibility for failing to detect the Bernie Madoff Ponzi scheme fraud.⁵¹ Such criticisms considerably weakened the SEC's position as a regulator, making it harder for it to resist political sentiment favouring short selling restrictions.⁵²

Further, and demonstrating longstanding public suspicion towards short sellers, the SEC received over 4,000 requests to reinstate a short sale price test following the crisis, with the overwhelming majority of these coming from individual investors.⁵³ Indeed, the SEC stated that although it was not aware of specific empirical evidence that the removal of the uptick rule contributed to increased volatility in the markets in 2008, it recognised that many members of the public

⁴⁹ Ibid 120.

⁵⁰ Erik R. Sirri, 'Regulatory Politics and Short Selling' (2010) 71 *University of Pittsburgh Law Review* 517, 534-535.

⁵¹ For a brief discussion of the Madoff scandal and Ponzi schemes, see e.g. Amy Wilson, 'Bernard Madoff: What Is a Ponzi Scheme and How Does It Work?' *The Telegraph* (15 December 2008). See also Sirri (n 50) 535; David P. McCaffrey, 'Review of the Policy Debate over Short Sale Regulation During the Market Crisis' (2009) 73 *Alb L Rev* 483, 514-515.

⁵² McCaffrey (n 51) 516.

⁵³ Ibid 504, 516. A further short selling rule, Rule 204 Regulation SHO, was also introduced in 2009 to combat the risk of fails to deliver arising from naked short selling. This was also a far-reaching regulatory step that virtually precludes naked short selling. See further Chapter 4, section 4.3.

associated the removal of the former uptick rule with increased volatility.⁵⁴ Consequently, in terms of introducing post-crisis short selling reforms, the SEC was likely to have been seeking to both ‘please Congressional critics’,⁵⁵ and placate the public, rather than ensuring any new regulations were actually appropriate.

With this in mind, although the SEC refrained from reintroducing the uptick rule, it did introduce an ‘alternative uptick rule’ in early 2010.⁵⁶ Given the SEC’s view that short selling was not the root, or even a contributing factor to the financial crisis,⁵⁷ implementing this rule was also likely triggered by the need to keep Congress happy, and to address populist concerns that existed about short selling.

3.4 The Sovereign Debt Crisis and the European Response

Moving across the Atlantic, short selling was also not top of the European regulatory reform agenda. The Commission, who initially had been fairly sanguine about the scale of the crisis,⁵⁸ then focused its EU reform programme on what had been agreed internationally at the Washington G20 summit in November 2008, which as we have observed, contained no specific mention of short selling.

⁵⁴ SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (February 26, 2010), 21-22.

⁵⁵ Sirri (n 50) 535.

⁵⁶ Regulation SHO, Rule 201.

⁵⁷ SEC (n 54) 21-22. See also Helena Stigmark, ‘Should Short Selling Be Regulated as a Consequence of Wall Street’s Failures? Exploring the New Alternative Uptick Rule’ (2010) 30 *The Michigan Business Law Journal* 32.

⁵⁸ Moloney, ‘EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?’ (n 1) 1335.

Separate to this however, at the European level, the Committee of European Securities Regulators ('CESR'),⁵⁹ started investigating further convergence on short selling. It launched a review of policy in July 2009 with a view to formulating pan-European standards on short selling. This resulted in a March 2010 report proposing a pan-European two-tier disclosure regime with respect to shares.⁶⁰ As will be discussed further in Chapter 5, CESR's model has now been implemented in the Regulation's provisions.⁶¹

In addition, following the implementation of various unilateral and uncoordinated short selling bans during the crisis, there were also calls by the Council of the European Union⁶² (the 'Council') in early 2009 to enhance greater convergence between the Member States regarding short selling temporary measures. The Council requested that the Commission look further into these issues whilst also supporting CESR's on-going work.⁶³

The Commission also asked the European Securities Markets Expert Group ('ESME'), an independent advisory group to the Commission, to evaluate certain aspects of short selling and ESME produced a report in March 2009.⁶⁴ This report, in a similar vein to IOSCO's, recognised short selling's integral part in the functioning of markets, emphasised that the effectiveness of short selling restrictions had not been

⁵⁹ See CESR, *New Steps by CESR to Address the Recent Market Crisis* (1 October 2008).

⁶⁰ CESR, 'Report: Model for a Pan-European Short Selling Disclosure Regime' (March 2010) 3.

⁶¹ It has also been extended to encapsulate notifications to regulators concerning the short selling of sovereign debt.

⁶² National ministers from each EU country meet at the Council to adopt laws and coordinate policies.

⁶³ Council of the European Union, *Press Release: Economic and Financial Affairs* (10 February 2009) 12. This was not the predominant focus of the meeting however, included in a section termed 'Other Business'.

⁶⁴ European Securities Markets Expert Group, 'Position on Short Selling' (19 March 2009).

borne out by the evidence, and considered that restrictions adversely affected markets and participants.⁶⁵ Further, in April 2009, the Commission also asked general questions about short selling when reviewing the Market Abuse Directive ('MAD'). However the general consensus was that short selling was not market abuse and that it raised different issues.⁶⁶

Thus, prior to the onset of the sovereign debt crisis, short selling regulation was not a top priority within Europe and moves towards producing harmonised European rules were progressing slowly at best, with relatively measured, carefully considered regulatory suggestions being put forward by CESR and ESME.

3.4.1 Focusing Events

Within the EU, the global crisis was not one that merely affected the capital markets however. Bank rescues put in place by Member States in 2008 onwards put enormous pressure on several Member States' sovereign debt and quickly transformed the crisis from one that only affected financial markets into a eurozone fiscal crisis.⁶⁷ In particular, in early 2010, a number of European countries, including Greece, began to show signs of imminent financial collapse. As the Greek crisis started to unfold, short positions, including short sales and CDSs on Greek debt increased.⁶⁸ In particular

⁶⁵ Ibid 2-3.

⁶⁶ Commission, 'Public Consultation on Short Selling' (14 June 2010) 2.

⁶⁷ Jennifer Payne and Elizabeth Howell, 'The Creation of a European Capital Market' in Panos Koutrakos and Jukka Snell (eds), *Research Handbook on the Law of the EU's Internal Market* (Edward Elgar forthcoming 2015) 14.

⁶⁸ Bloink (n 4) 598.

those taking short positions were blamed by the Greek government for worsening the situation by decreasing investor confidence in Greek debt.⁶⁹

In March 2010, some governments started to raise concerns about the possible role played by CDSs in relation to the price of Greek sovereign bonds. Specifically, on 10 March, Germany and France, supported by Luxembourg and Greece, wrote to Jose Barroso, Commission President, and Spanish Prime Minister Jose Zapatero, who held the rotating Presidency of the EU. They proposed that the EU initiated an inquiry as quickly as possible into the role and impact of speculative practices associated with CDS trading in government bonds of European countries. They stated that should the inquiry ascertain market abuses, or that there was a well-founded suspicion that speculative practices were having a considerable impact on bond yields, the EU should quickly examine measures to determine whether they were suitable, and if necessary, pass legislation. These legislative measures should include introducing minimum holding periods for CDSs, banning speculative CDS trading, and banning CDSs not used for hedging purposes.⁷⁰

In response to these concerns, the Commission announced in its 2010 work programme that it would include a legislative initiative on short selling and CDSs as a strategic initiative.⁷¹ It was still not the Commission's top priority,⁷² although in contrast to prior work on short selling, sovereign CDSs had now entered the debate.

⁶⁹ Ibid 598.

⁷⁰ See e.g. Stephen Fidler, 'What Sarkozy, Merkel Wrote on CDS' *The Wall Street Journal* (11 March 2010).

⁷¹ Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions Commission Work Programme 2010 Time to Act' (31 March 2010) 4.

⁷² Within its programme, the short selling initiative was included as one of several proposals to ensure stable financial markets, termed 'strategic initiative 3'.

The situation in the eurozone continued to deteriorate, and in April 2010, Greek sovereign debt was downgraded to junk status: the lowest credit rating in the eurozone.⁷³ At this point, Greek regulators also took the decision to temporarily ban short selling in shares listed on the Athens exchange. When the situation became untenable, the EU was forced to take action or face the prospect of one of its members crashing out of the euro. Given the consequences of Greece defaulting, including the fallout for other struggling eurozone countries, the EU had little choice but to bailout Greece, and a package was agreed on 2 May 2010.⁷⁴

Weeks later, and reportedly on the request of the German Finance Minister, Wolfgang Schäuble, Germany then shocked the markets with a unilateral prohibition on the naked short selling of sovereign debt, and naked CDSs on euro-area government bonds.⁷⁵ Given the unilateral nature of the act, the decision was likely to have been politically driven, caused by domestic pressure on the German Chancellor Angela Merkel who was facing criticism within the Christian Democrat Party over her response to the Greek crisis.⁷⁶ Indeed the timing was certainly politically significant, given it came shortly before the German Parliament initiated the debate

⁷³ Bloink (n 4) 599.

⁷⁴ Ibid 599. See also 'Eurozone Approves Massive Greece Bail-Out' *BBC News* (2 May 2010). It should be observed however that, at the time of writing, the spectre of Greek default continues to loom over the eurozone, see e.g. Ian Traynor and Helena Smith, 'Greece Submits Reform Document in Bid to Secure Bailout Extension' *The Guardian* (24 February 2015).

⁷⁵ Matteo Gargantini, 'The ESMA Decision: Implications for the Governance of ESAs' (Conference on the Landmark 2014 ESMA decision of the ECJ, Luxembourg, 27 March 2014); Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (n 1) 1364-1365. See also Tony Barber and Ben Hall et al., 'German Curbs Raise Tensions in Europe' *Financial Times* (20 May 2010). The ban also covered naked short selling of shares in particular financial institutions.

⁷⁶ Tony Barber and Gerrit Wiesmann, 'Berlin Makes Shock Move without Allies' *Financial Times* (20 May 2010). The article in fact states that the move was aimed at quelling disquiet in the Christian Democrat party. See also Moloney, *EU Securities and Financial Markets Regulation* (n 32) 544.

about authorising German's contribution to the emergency support fund for indebted European periphery nations.⁷⁷

The ban caused enormous market turmoil and triggered a sell-off, and other Member States, including France, were highly critical of the German action that had been announced without consultation.⁷⁸ Likewise, traders reportedly indicated that such a unilateral action came as a surprise and created a feeling of 'what did the Germans know that they didn't' leading to intense long selling.⁷⁹ Further, the sense that Germany had also acted partly as a cynical attempt to improve its own finances was compounded by its ability to simultaneously issue new debt at the cheapest rate since 1998, aided by the 'short squeeze' created by the ban.⁸⁰

3.4.2 Germany and France: Political Entrepreneurs Utilise the Crisis

Although France had initially stopped short of supporting Germany's unilateral action against the short sellers, weeks later, with the continued deepening of the sovereign debt crisis, Nicolas Sarkozy joined Chancellor Merkel in calling for a EU prohibition of naked short selling. On 8 June 2010 they wrote again to Commission President Barroso, in a letter widely reported by the world's media. They called for a EU-wide prohibition on naked short selling of all or certain shares and sovereign bonds, as well

⁷⁷ 'Germany's Naked Short-Selling Ban: What the Analysts Say' *The Guardian* (19 May 2010).

⁷⁸ Specifically, implementing a unilateral ban without any coordination between the authorities would create side effects for other markets as short sellers would merely shift to other markets, Matteo Gargantini (n 75).

⁷⁹ See *ibid.*

⁸⁰ Broadly, the ban forced traders to close out their positions and buy bonds, see Harry Wilson, 'Markets Crash as German Short-Selling Ban Bites' *The Telegraph* (19 May 2010). The actions subsequently led to permanent German regulations being introduced in July 2010 prohibiting the naked short selling of all shares, specific government bonds, and naked CDSs on government bonds, see The Abusive Securities and Derivatives Trades Prevention Act (*Gesetz Zur Vorbeugung Gegen Missbräuchliche Wertpapier Und Derivategeschäfte*) 2010. France also took legislative action.

as of all or certain naked sovereign CDSs, to prevent the European financial markets from suffering a new wave of severe turbulence.⁸¹ The two leaders noted that the turbulence had led to ‘considerable concern among the Member States of the European Union and all our fellow citizens’.⁸² They stressed that there was an urgent need for the Commission to speed up its work to establish stricter controls of markets in sovereign CDSs and of short selling, and also believed it was indispensable to reinforce the transparency of short positions in shares and sovereign bonds.⁸³

Given that it was countries such as Greece, Spain, and Portugal whose sovereign bond markets were most affected by any alleged speculation, one might have expected it to be them, rather than France and Germany, to be arguing most vehemently for new restrictions. With this in mind, such forceful Franco-German actions, spoke particularly of politicians seeking to capitalise on the opportunities presented by the crisis to further their own political interests. In France, Sarkozy had forthcoming Presidential elections looming in spring 2012, whilst in Germany, Chancellor Merkel had already come under fire from her party and constituents over the cost of the emergency eurozone bailout package that had been agreed.⁸⁴ Further, although the next federal elections were not until 2013, various state elections were on the horizon. Consequently, taking a hard stance, particularly against naked short sellers, was likely to prove popular with the voters. Given that, with the assistance of the world’s media, naked short sellers were already perceived practically as

⁸¹ Nicolas Sarkozy and Angela Merkel, *Letter to President of the European Commission* (8 June 2010).

⁸² *Ibid* 1.

⁸³ *Ibid* 2.

⁸⁴ Barber and Wiesmann, (n 76).

vagabonds, pinning the blame of shorters was a quick fix that helped deflect blame from politicians' own inadequacies and errors.⁸⁵

Notably, Sarkozy and Merkel's practice of sending out highly charged joint communications with shared priorities also extended beyond short selling regulation.⁸⁶ For example, in May 2010, the two leaders had previously written to President Barroso attacking the credit rating agencies for their role in the sovereign debt crisis, and calling for tough measures to be taken to curb their influence over the markets.⁸⁷ Indeed, more generally it has been suggested that such practices provided evidence of the increasing dominance of a more intrusive regulatory style, which reflected Franco-German choices.⁸⁸ Although in the pre-crisis landscape, the British 'light touch' and 'disclosure focused' policymakers had been particularly influential at the European level, since the start of the global financial crisis, this approach had been discredited.⁸⁹ This also paved the way for the rise of a new pecking order within the EU: a more stability-orientated, less market friendly, 'trading bans' approach to regulation, associated particularly with France and Italy, and also to a lesser extent with Germany and Spain.⁹⁰

3.4.3 Consequences: A Swift Short Selling Consultation

⁸⁵ 'Banning Naked Short-Selling Won't Solve the Eurozone Crisis' *The Guardian* (6 July 2012).

⁸⁶ Eilis Ferran, 'Crisis-Driven EU Financial Regulatory Reform' (2012) University of Cambridge Faculty of Law Legal Studies Research Paper Series, 14 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2028003> accessed 1 July 2013.

⁸⁷ See e.g. Tony Barber and Tom Braithwaite, 'European Leaders Hit at Ratings Agencies' *Financial Times* (London, 7 May 2010).

⁸⁸ Ferran, 'Crisis-Driven EU Financial Regulatory Reform' (n 86) 14.

⁸⁹ Ibid 14. See also Lucia Quaglia, 'The 'Old' and 'New' Political Economy of Hedge Fund Regulation in the European Union' (2011) 34 *West European Politics* 665, 677.

⁹⁰ Ferran, 'Crisis-Driven EU Financial Regulatory Reform' (n 86) 14. See also Quaglia (n 89) 677-678.

By June 2010, the Commission had already stated that it would propose appropriate measures on short selling and CDSs with ‘particular reference to sovereign debt’,⁹¹ and noted that the measures would also address naked short selling.⁹² Then, six days after the Merkel-Sarkozy letter to President Barroso, the Commission announced its public consultation on short selling. The political steer from Germany and France was evident not only in the Commission’s swiftness of action, but also in the consultation itself, where the Commission stated that it was particularly concerned with naked short sales on shares and sovereign bonds, and with CDSs on sovereign debt.⁹³

3.4.3.1 Pre-Proposal Consultation

The pre-proposal consultation period is an important stage in the legislative process, as the Commission’s position on a topic is not meant to have crystallised at this stage.⁹⁴ Despite this however, the short selling consultation period ran to fewer than four weeks. Although CESR had previously carried out a longer consultation for its disclosure model,⁹⁵ it had also specifically limited the reach of this to transparency with respect to short sales in shares.⁹⁶ In contrast the Commission was now consulting on a far broader range of issues including complex proposals relating to the

⁹¹ Commission, ‘Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, and the European Central Bank Regulating Financial Services for Sustainable Growth’ (June 2010) 7.

⁹² Ibid 7.

⁹³ Commission, ‘Public Consultation on Short Selling’ (n 66) 9. See also Moloney, ‘EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?’ (n 1) 1372.

⁹⁴ Moloney, ‘EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?’ (n 1) 1340.

⁹⁵ In 2009 CESR had held almost a three-month consultation period.

⁹⁶ See further CESR, ‘CESR Proposal for a Pan-European Short Selling Disclosure Regime’ (July 2009) Annex.

naked short selling of shares, sovereign bonds and sovereign CDSs; plus types of emergency powers for competent authorities at both the domestic and European level.⁹⁷ As will be observed below, many were highly critical of the short timeframe,⁹⁸ and it has since been described as the ‘most notorious example of a squeezed consultation process’.⁹⁹ These criticisms are all the more worrying given the weight of restrictions then introduced by the legislation.¹⁰⁰

The impact of the prevailing political climate and the debt crisis was also reiterated on the Commission’s website where it stated that the rationale behind the very short consultation period was the ‘high political priority and urgency of the issue in the context of the financial crisis and recent volatility in Euro denominated sovereign bonds’.¹⁰¹ However the consultation paper itself provided no explanation for the short deadline.

3.4.3.2 Consultation Responses

⁹⁷ Commission, ‘Public Consultation on Short Selling’ (n 66) 8, 10, 15.

⁹⁸ See e.g. EuropeanIssuers, *Response to European Commission’s Public Consultation on Short Selling* (9 July 2010) 1, who was not convinced this case necessitated the short deadline and noted there was too high a probability of rushed drafting and unintended consequences. It also noted that many of the most difficult legislative dossiers over the past ten years had been those on which consultation has been inadequate.

⁹⁹ House of Lords European Union Select Committee, *The Post-Crisis EU Financial Regulatory Framework: Do the Pieces Fit?* (5th Report of Session 2014-2015, 2 February 2015) 39.

¹⁰⁰ Moloney, ‘EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?’ (n 1) 1340. Limited consultation periods were also apparent with respect to other proposed topics of regulation. For example consultations concerning credit rating agency, and hedge fund regulation also only lasted around four weeks, see *ibid* 1340.

¹⁰¹ Commission, ‘Consultation on Short Selling’ (2010) <http://ec.europa.eu/internal_market/consultations/2010/short_selling_en.htm> accessed 8 August 2013.

Responses were received from, amongst others, regulators, investors, finance ministries, exchanges, issuers, and individuals. Out of 124 responses received, 105 were publicly accessible on the Commission's website in English. Of these, approximately 78% were broadly supportive of some type of harmonisation, although a considerable number particularly, or only, supported greater harmonisation of disclosure requirements. In terms of supporting permanent restrictions or bans on naked short selling, only approximately 23% were in favour, and in relation to introducing permanent limitations on entering into naked CDSs relating to EU sovereign issuers, few responded to this question. Of those who did respond, only approximately 10% supported such a move.¹⁰²

General Criticisms

Broadly, it was considered that there was insufficient established evidence that short selling posed risks or required regulatory measures such as those proposed in the consultation.¹⁰³ Specifically it was observed that regulators should be blaming those responsible for fuelling the market bubble rather than those who rationally called for the end of the party,¹⁰⁴ and some questioned the phrasing of the consultation, noting

¹⁰² Figures calculated using the information available on the Commission's short selling consultation website, see *ibid.* Breaking the figures down, approximately 85% of registered organisations (including banking and trade associations and issuers), 76% of public authorities (including central banks and treasuries), and 69% of individual contributions (including exchanges and investors) broadly supported some type of harmonisation. Approximately 30% of registered organisations, 29% of public authorities, and 12% of individual contributions supported permanent restrictions on naked short sales, and only approximately 13% of registered organisations, 18% of public authorities and 5% of individuals supported permanent limitations on naked sovereign CDSs.

¹⁰³ See e.g. Federation of European Securities Exchanges, *FESE Response European Commission Public Consultation on Short Selling* (2010) 2; CFA, *CFA Society of France Comments on Public Consultation on Short Selling and Credit Default Swaps* (2010) 2; HFSB, *HFSB Response to the European Commission Public Consultation on Short Selling* (2010) 2-5.

¹⁰⁴ CFA (n 103) 3.

that asking which financial instrument gave rise to ‘risks of short selling’,¹⁰⁵ suggested the Commission had already concluded short selling was detrimental but had not provided any evidence to support this.¹⁰⁶

As observed, the very short consultation deadline was also highly criticised and there were warnings against rushed policy decisions.¹⁰⁷ It was noted that no exceptional reasons were included for having such a short consultation, and that this was not acceptable for a ‘complex and complicated issue like short selling’.¹⁰⁸ Concerns about acting under short-term political reasoning, including the media and political tendency to demonise short selling, were also raised.¹⁰⁹ Likewise, it was observed that the political discussion about the potential effects of short selling seemed to be based on irrational and unfounded assumptions resulting in a perception whereby short selling was stigmatised as being generally suspicious if not abusive per se.¹¹⁰

*Should Naked Short Sales be subject to Permanent Restrictions?*¹¹¹

¹⁰⁵ Commission, ‘Consultation on Short Selling’ (n 66) 4.

¹⁰⁶ See e.g. London Stock Exchange Group, *LSEG Response to European Commission’s Consultation on Short Selling* (9 July 2010) 1-2; NASDAQ OMX, *European Commission Public Consultation on Short Selling* (July 2010) 1.

¹⁰⁷ See e.g. EBF, *Response to the European Commission’s Public Consultation on Short Selling* (2010) 2; CSE, *Confederation of Swedish Enterprise: Public Consultation on Short Selling: Comments by the Confederation of Swedish Enterprise* (June 2010) 1.

¹⁰⁸ CSE (n 107) 1.

¹⁰⁹ See e.g. BusinessEurope, *Stakeholder Consultation on Short Selling* (20 July 2010) 5; Czech National Bank, *Public Consultation on Short Selling: Opinion of the Czech National Bank* (2010) 1; Flow Traders B.V., *Resonse to Public Consultation on Short Selling* (9 July 2010) 2.

¹¹⁰ BWF, *Public Consultation on Short Selling* (9 July 2010) 1. BWF (a trade association) also noted that the Commission statement that in some situations short selling could be used in an abusive fashion was nothing but a presumption regarding a very vague potential link between short selling and adverse market effects, and this was insufficient to justify potential future restrictions.

¹¹¹ Commission, ‘Consultation on Short Selling’ (n 66) questions 11 and 14.

Turning to naked short selling constraints, despite the fact naked short sales had gained much attention in the recent political debate, it was highlighted that there was very limited evidence that it posed particular risks to the market.¹¹² One respondent would not take any position on the proposals as they could not find any description in the consultation detailing the problems the proposals would solve regarding naked short sales, and there were no hard facts or reports to support the very vague statements that there may be increased price volatility in the case of naked short sales.¹¹³

*Evidence of Risks of Uncovered Short Sales in Sovereign Debt?*¹¹⁴

With respect to extending requirements to uncovered short sales in sovereign debt, the general consensus was that there was very little evidence of risks for instruments other than shares and respondents cautioned against a regulatory over-reaction.¹¹⁵ Likewise it was highlighted that banning uncovered short selling of bonds would constitute a significant cost for governments, investors and dealers.¹¹⁶ Further, although market-wide data was hard to obtain, it was observed that the actual percentage of such trades failing was very small and this had only a limited impact on the markets.¹¹⁷ The importance of sovereign debt markets in times of financial stress

¹¹² BWF (n 110) 5. See also BBA, *European Consultation on Short Selling: A Response by the British Bankers' Association* (July 2010) 11.

¹¹³ CSE (n 107) 1.

¹¹⁴ Commission, 'Consultation on Short Selling' (n 66) question 12.

¹¹⁵ See e.g. European Banking Federation, *Response to the European Commission's Public Consultation on Short Selling* (9 July 2010) 12.

¹¹⁶ AFME, ISLA and ISDA, *AFME, ISLA and ISDA Joint Response to the European Commission's Public Consultation on Short Selling* (9 July 2010) 3.

¹¹⁷ Ibid 14-15. See also Barclays Capital, *Barclays Capital Response to the European Commission Public Consultation on Short Selling* (July 2010) 10.

was reiterated and it was stated that short selling in sovereign bonds did not pose a risk and that settlement failure was extremely rare.¹¹⁸

*Permanent Restrictions on Entering Uncovered Sovereign CDSs?*¹¹⁹

There was little response to this question and, from those who did, little support for introducing permanent restrictions. Issues highlighted here will also be explored further in Chapter 6, but it was considered that extending restrictions into the sovereign debt markets could increase the cost for Member States issuing such debt in the future. It was also noted that the relative amount of naked CDSs in recent sovereign debt controversies was also rather minor compared with the outstanding amount of bonds.¹²⁰ Indeed it was emphasised that the sovereign CDS market was extremely small in comparison with the sovereign bond market and there was no evidence of manipulative short selling of bonds, or of manipulation of the relationship between EU sovereign CDSs and sovereign bond prices.¹²¹ In particular, analysis of Depository Trust and Clearing Corporation ('DTCC') data for the Greek sovereign CDS and bond markets demonstrated that the former was very small compared to the latter,¹²² suggesting any manipulation was near impossible.¹²³ Finally, as we observed

¹¹⁸ Dansmark Nationalbank, *Response by Danmarks Nationalbank to the European Commission's Public Consultation on Short Selling* (8 July 2010) 4.

¹¹⁹ Commission, 'Consultation on Short Selling' (n 66) question 16.

¹²⁰ ABBL, *Luxembourg Bankers' Association Response to the EU Commission: Public Consultation on Short Selling* (2010) 3.

¹²¹ FSA, HMT and Debt Management Office, *Joint FSA/HMT/Debt Management Office Response to the European Commission Public Consultation on Short Selling* (2010) 2, 10.

¹²² *Ibid* 10. For example in January/February 2010, for Greek sovereign CDSs there were approximately \$9 billion net volume outstanding contracts compared with over \$400 billion outstanding debt in the bond markets.

¹²³ *Ibid* 10. Barclays Capital reiterated this, stating there was very limited causal relationship between activity in the CDS markets and the deteriorating market price of the underlying debt, see Barclays Barclays Capital (n 117) 4. Separately, ISDA issued a statement with respect to the DTCC reports that

in Chapter 2, it was also noted that the majority of intensive selling behaviour during stressed moments could be attributed to conventional investors, as witnessed by the relentless selling even after short sales were banned in 2008.¹²⁴

German and French Support

Perhaps unsurprisingly, the German Government's Federal Ministry of Finance, supported the proposals for a naked short selling ban and a permanent ban of uncovered sovereign CDSs. It stated that uncovered short sales could endanger the stability of the financial system, and that naked CDSs could cause considerable risks, especially in stressed situations.¹²⁵ Similarly, France's central bank, the Banque de France, stated that short selling posed many issues, considered naked short selling to be a very hazardous technique that should be prohibited, although it did not support a naked CDS ban, proposing other measures including greater supervision and heightened transparency.¹²⁶

Assessment

showed the net outstanding CDSs on Greece had changed little: it was \$8.7 billion in January 2010 and then had ranged between \$8.5 and \$9.2 billion since then. The data also indicated that the net position for Greece the previous year was \$7.4 billion, nothing suggested a surge in open interest since then, ISDA, 'ISDA Comments on Sovereign CDS' <<http://www.isda.org/media/press/2010/press031510.html>> accessed 14 August 2013. See also HFSB (n 103) 8.

¹²⁴ Investment Quotient, *European Commission Public Consultation on Short Selling* (9 July 2010) 2.

¹²⁵ Germany Federal Ministry of Finance, *Comments on the European Commission's Consultation Paper on Short Selling* (13 July 2010) 5-7.

¹²⁶ Banque de France, *Banque De France Response to the European Commission Public Consultation on Short Selling* (2010) 6-9.

In sum, the consultation was a hurried affair: it failed to provide any concrete evidence as to the perceived greater risks of naked short selling, and was driven by a prevailing sense of political urgency. Aside from Germany and France, the industry largely did not support the proposals to restrict the naked short selling of shares or sovereign debt, and hardly any supported prohibitions on uncovered CDSs on EU sovereign issuers. Many questioned the process's politicisation, and the Commission's conclusion that short selling was detrimental without providing evidence to support this.

3.4.4 Legislative Procedure

3.4.4.1 The Proposal

Published on 15 September 2010, both the Commission Proposal (the 'Proposal'), plus its accompanying Impact Assessment, drew on the experience of the financial and sovereign debt crises. Specifically there was much rhetoric with respect to systemic risks, and also in relation to the problems of regulatory arbitrage that stemmed from the uncoordinated, go-it-alone, national responses that had taken place during autumn 2008.¹²⁷ The Proposal was also a response to jurisdictions including the US who had subsequently updated their short selling rules since the crisis, to ensure the EU did not lag behind.¹²⁸ However, and in contrast to the US's approach to short selling regulation post-crisis, the Proposal and Impact Assessment also drew on the concerns raised by some governments with respect to sovereign debt concerns.

¹²⁷ Impact Assessment (n 23) 20-21.

¹²⁸ Ibid 34; Commission Proposal for a Regulation on Short Selling and Certain Aspects of Credit Default Swaps COM(2010) 482 3.

Notably as well, rather than considering the risks of the short selling of sovereign debt more generally, the focus was specifically on the debt crisis and the Greek sovereign debt markets.¹²⁹

The Commission acknowledged there was limited or no evidence of risks relating to short selling, including naked short selling, that there no clear empirical evidence showing a causal link between short selling and negative price spirals, and that several regulators had no evidence or experience of naked short selling or of any real settlement problems occurring as a result of naked short selling.¹³⁰ The Commission also acknowledged that most respondents did not consider there to be risks for instruments other than shares, and that those who answered the question as to a ban on naked sovereign CDSs pointed out there was no evidence of a problem.¹³¹ Further, the Commission also recognised in its Impact Assessment that there was very limited empirical evidence available (aside from the unilateral German ban) with respect to prohibitions on the short selling of sovereign debt or with respect to uncovered sovereign CDSs.¹³²

Nevertheless, despite the lack of evidence of risks, or the existence of strong evidence with respect to the sovereign debt markets, the Commission set out permanent restrictions on both uncovered short sales of shares and sovereign debt in

¹²⁹ Moloney, *EU Securities and Financial Markets Regulation* (n 32) 548; Impact Assessment (n 23) 24.

¹³⁰ Impact Assessment (n 23) Annex 4. Approximately 14 regulators had anonymously made such comments during the impact assessment.

¹³¹ Ibid 25, Annex 2.

¹³² Ibid 19-20; 43-44; Moloney, *EU Securities and Financial Markets Regulation* (n 32) 548. Specifically such markets suffered from a lack of data as participants tended to maintain positions in the secondary markets and trade over-the-counter.

its Proposal.¹³³ Specifically the proposal contained a hard ‘locate’ rule for shares and sovereign debt: a highly constraining requirement.¹³⁴ Such a rule obliged a short seller to have at least an arrangement under which a third party confirmed that the shares or sovereign debt instrument had been located and reserved, rather than only requiring the broker or dealer to have reasonable grounds to believe it could be borrowed, as was the case in the US. The Commission described this as a proportionate response to the risk of settlement failure whilst also reducing the risk of negative price spirals.¹³⁵

Notably however, the Commission held back from permanently restricting naked CDSs on EU sovereign issuers, instead subjecting them to a notification requirement and providing that Member States could limit CDSs relating to ‘an obligation of a Member State’ in exceptional situations.¹³⁶ The Commission observed that the industry was broadly opposed to a ban and that the sovereign CDS markets were only a tiny fraction of the underlying bond market. It also noted that this difference in size between the markets would likely play a role in limiting the effects of a negative price spiral.¹³⁷

Task Force Report

¹³³ See Short Selling Proposal (n 128) Art 12.

¹³⁴ For further analysis of the locate rule, see Chapter 4.

¹³⁵ Impact Assessment (n 23) 49. The Commission also introduced a reporting regime based on CESR’s two-tier disclosure model but further extended this to also cover sovereign debt positions. It also included a requirement for marking short sale orders executed on trading venues and for the venue to publish daily information concerning short sale volumes.

¹³⁶ Short Selling Proposal arts 8 and 18.

¹³⁷ Impact Assessment (n 23) 25, 43.

In contrast to the proposed tight restrictions on naked short sales and sovereign debt, the Commission's relatively cautious approach to sovereign CDSs may have been influenced especially by the findings of a report prepared by a Commission task force in May 2010 that only became public in December 2010 following a freedom of information request by a Dutch newspaper.¹³⁸ This report will be examined in more detail in Chapter 6, however the task force reviewed the functioning of the sovereign CDS market and analysed its link to the underlying bond market. In particular it found no conclusive evidence that developments in the CDS market had led to higher funding costs for Member States.¹³⁹ The report stated that CDS spreads for troubled countries seemed to be low relative to the corresponding bond yield spreads, implying that CDS spreads could hardly be considered to be causing high bond yields in these countries.¹⁴⁰ It also concluded that the differences in bond and CDS spreads across countries was justified and that government deficits, debt levels, and current account deficits gave a consistent picture of vulnerabilities.¹⁴¹

Although the Commission was rightly criticised for its failure to publish the report when it was originally prepared, its restrained approach to naked sovereign CDS regulation in the Proposal did broadly reflect the report's conclusions. Unfortunately however, even once the report was available, its findings still failed to halt those campaigning for greater curbs on the sovereign naked CDS market.

¹³⁸ William Hutchings, 'Secret' EC Report Clears Hedge Funds over Greek Default' *Financial News* (7 December 2010).

¹³⁹ Commission, 'Task Force Report on Sovereign CDS', 3 <<http://online.wsj.com/public/resources/documents/ReportonsovereignCDS12072010.pdf> (<http://perma.cc/6YFM-4ATV>)> accessed 20 August 2013.

¹⁴⁰ Ibid 4.

¹⁴¹ Ibid 15.

3.4.4.2 Negotiations: Input of the Member States, the Council and the Parliament

The Proposal was submitted to both the Council and the Parliament to be considered in parallel,¹⁴² and in November 2010, following examination by the Council's Working Party on Financial Services, the Council produced a progress report.¹⁴³ This noted that some delegations were concerned about the regulation going beyond notification and disclosure rules.¹⁴⁴ There was also some strong opposition to the inclusion of sovereign debt instruments in the Proposal as it was felt the rules could be detrimental to the functioning and liquidity of the market.¹⁴⁵ Views were also divided on the need to impose permanent restrictions on naked short selling, and more specifically on the need to impose restrictions in relation to sovereign debt instruments.¹⁴⁶ Finally, there were also concerns voiced about the emergency powers of the newly created authority ESMA to intervene in the markets in the case of unjustified inaction by a NCA.¹⁴⁷ A number of delegations felt this measure went too far and did not want ESMA interfering in the sovereign debt markets without the consent of the Member State authority.

Turning to the Parliament, the Proposal was referred to its Economic and Monetary Affairs Committee (the 'Committee'), and Pascal Canfin was appointed as

¹⁴² Under the ordinary legislative procedure (formerly known as the co-decision procedure), the Parliament and the Council would have to jointly agree on the new law.

¹⁴³ Council of the European Union, 'Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps: Progress Report' 26 November 2010 . A compromise proposal was also produced that contained relatively minor amendments, see Council of the European Union, *Presidency Compromise* (19 November 2010).

¹⁴⁴ Union, 'Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps: Progress Report' (n 143) 2.

¹⁴⁵ *Ibid* 2.

¹⁴⁶ *Ibid* 2.

¹⁴⁷ *Ibid* 3.

the lead MEP (the ‘Rapporteur’), responsible for drawing up a draft report containing proposed amendments to be approved by both the Committee and the full Parliament. Notably, previously, the Parliament had already taken a particularly hostile view of short selling, especially naked short selling, with respect to the negotiations concerning the Alternative Investment Fund Managers Directive (‘AIFMD’) where it had proposed banning naked short selling in the EU.¹⁴⁸ Perhaps unsurprisingly then, on 7 March 2011, the Committee, in line with the preferred view of the Rapporteur, voted to toughen up the Proposal by effectively banning naked sovereign CDSs.¹⁴⁹ The Committee also voted in favour of tight restrictions on naked short sales with some MEPs suggesting that such traders had an incentive to drive down the price of a share or a bond, thereby needlessly damaging a company or an economy.¹⁵⁰ The Committee’s approach lacked any economic foundations and spoke particularly of the Parliament’s continued animosity towards speculators and short selling.

Consequently, when Member State ambassadors met two days later to thrash out an agreement for the finance ministers to endorse at their forthcoming Economic and Financial Affairs (‘ECOFIN’) meeting, they remained divided on the draft rules. Germany and France continued their joint push for tough regulation including the ban on naked sovereign CDSs, while Member States including the UK, Italy and the

¹⁴⁸ European Parliament Committee on Economic and Monetary Affairs, *Report on the Proposal for a Directive on Alternative Investment Fund Managers* (A7-0171/2010) 12-13; Moloney, *EU Securities and Financial Markets Regulation* (n 32) 544.

¹⁴⁹ European Parliament, *Report on the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps* (19 April 2011).

¹⁵⁰ ‘MEPs Vote for ‘Naked’ Short-Selling Restrictions’ *BBC Business News* (8 March 2011).

Netherlands argued that this could impede recovery from the crisis and increase funding costs for governments.¹⁵¹

Political Compromise Reached?

In the absence of a general approach being reached, triologue discussions then commenced between the Presidency, the Council, and the Parliament. During this time France and Germany argued most vociferously in the Council in favour of strict regulation.¹⁵² Two months later, in May 2011, the finance ministers finally reached a watered-down compromise deal that included a subtler approach to naked short sale restrictions for shares and sovereign debt.¹⁵³ This also provided that the restrictions would not apply to sovereign debt if this hedged a long position in the debt instrument of an issuer.¹⁵⁴ It was also agreed that the sovereign debt restrictions (including those on sovereign CDSs) could be temporarily suspended if the liquidity of sovereign debt fell below a certain level. Again, there was no legal or economic justification supporting the separate rules to shares and sovereign debt, only political concerns that

¹⁵¹See 'EU Short-Selling Regulation on Ice' *EurActiv with Reuters* (10 March 2011). Specifically, Italy's public debt came under attack by speculators during 2011 and Italy was particularly concerned as to the impact of a ban on the pricing of government bonds, see 'EU Short-Selling Talks Collapse Amid Sovereign Debt Fears' *EurActiv* (22 September 2011). See also the House of Lords Select Committee on the EU that supported removing restrictions in the Proposal on naked short selling and CDSs on sovereign bonds, House of Lords Select Committee on the European Union, *Letter to Mark Hoban MP and Financial Secretary to the Treasury on Commission Proposal on Short Selling* (8 March 2011).

¹⁵² House of Commons European Committee, *Short Selling and Credit Default Swaps* (5 April 2011).

¹⁵³ The Council had in fact proposed this back in February 2011, see AIMA, 'AIMA's Response to Consultation Paper "Draft Technical Standards on the Regulation (EU) xxxx/2012 of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps" (13 February 2012) Appendix.

¹⁵⁴ Council of the European Union, *Council Agrees General Approach on Short Selling and Credit Default Swaps* (17 May 2011) 2; Council of the European Union, *Revised Presidency Compromise* (6 May 2011) article 12a. See also Simon Taylor, 'Agreement Struck on Short-Selling' *European Voice* (19 May 2011).

the restrictions could affect the management of countries' budget deficits explained the lighter restrictions on sovereign debt.¹⁵⁵

The agreed position, adopted by the Council, enabled the Presidency on behalf of the Council to then start negotiations with the Parliament. However the agreed deal stopped short of German demands for a permanent ban on naked sovereign CDSs. The agreed deal also frustrated many MEPs who also supported the German calls for a ban.¹⁵⁶ A German centre-right MEP warned that the Parliament would insist on limits to naked sovereign CDSs,¹⁵⁷ and Germany's Deputy Finance Minister also stated he would push for such a ban to be included in the final legislation.¹⁵⁸

3.4.4.3 Further Delays and New Bans

Although further talks then commenced between MEPs, the Council, and the Commission, they failed to reach a deal over summer 2011. In a Council report on the outcome of the Parliament proceedings, the Rapporteur stated that the Parliament had not yet voted on a legislative resolution, leaving open the possibility to continue negotiations with the Council.¹⁵⁹ The Rapporteur again favoured banning naked sovereign CDSs and stressed that his position had large support within the Parliament, with some MEPs even expressing the view that such practices would not be allowed

¹⁵⁵ Commission, 'Short Selling: Technical Standards – Frequently Asked Questions' (2012) 3. The daily marking requirement on short sale orders was also removed.

¹⁵⁶ Specifically it was reported that Chancellor Merkel had called for a ban in a 'bid to win back a disenchanted electorate', see Claire Davenport, 'Short-Selling Ban Row to Be Continued in Parliament' *Euractiv* (18 May 2011).

¹⁵⁷ *Ibid.*

¹⁵⁸ *Ibid.*

¹⁵⁹ Council of the European Union, *Proposal for a Regulation on Short Selling and Certain Aspects of Credit Default Swaps: Outcome of the European Parliament's Proceedings* (14 July 2011).

in national lotteries or casinos.¹⁶⁰ However the areas of disagreement also extended beyond CDSs. Specifically the Parliament and Member States were also still at odds over the intervention powers of ESMA, with Member States continuing to seek a veto power over ESMA decisions with respect to sovereign debt: a point also opposed by the Parliament.¹⁶¹

Separately, due to further volatility in the markets, in August 2011, with ESMA's backing, France, Italy, Belgium, and Spain then introduced further temporary short selling bans, restricting short selling of certain banking and financial securities.¹⁶² Considering how ineffective the 2008 temporary restrictions had been, this was a surprising development.¹⁶³ This time the market disruptions were triggered by rumours about the health and funding needs of indebted governments at the centre of the sovereign debt crisis, and concerns that countries such as France were heavily exposed.¹⁶⁴ Other Member States however, including the UK, the Netherlands, and Austria refused to follow suit in introducing bans. Indeed, given the empirical findings in Chapter 2 that established the 2008 prohibitions had neither prevented price falls nor reduced volatility, many were highly critical of the actions.¹⁶⁵

¹⁶⁰ Ibid 2-3; Moloney, *EU Securities and Financial Markets Regulation* (n 32) 546.

¹⁶¹ Ian Wishart, 'Council, MEPs at Odds on Short-Selling and Supervision' *European Voice* (7 July 2011) 2; Union, *Council Agrees General Approach on Short Selling and Credit Default Swaps* (n 154) 2.

¹⁶² ESMA, *ESMA Promotes Harmonised Regulatory Action on Short-Selling in the EU* (2011). This followed a move by Greece who had also introduced a short selling ban earlier in August 2011.

¹⁶³ Karmel (n 37) 880.

¹⁶⁴ See e.g. Helia Ebrahimi, 'Shorting Ban Sparks Anger but Lifts Banks' *The Telegraph* (12 August 2011); Sophie Walker and Janet Guttman, 'Europe Short-Selling Ban Reveals Divisions' *Reuters* (12 August 2011). Germany did not participate in the ban but as already observed, Germany had introduced a permanent regime in July 2010 involving bans on some forms of short selling, sovereign debt, and sovereign CDSs.

¹⁶⁵ See e.g. Alex Barker, 'Short-Selling Ban Attacked by Academics and Investors: Prohibition Seen as Unlikely to Curb Volatility' *Financial Times* (13 August 2011); Managed Funds Association, *Letter to ESMA on Short Selling Restrictions* (2011).

A month later, the short selling negotiations collapsed again due to fears that any legislation would further destabilise the eurozone's sovereign debt markets. Naked sovereign CDSs continued to be the bone of contention, with MEPs, backed by Germany continuing to push for a ban.¹⁶⁶ Indeed at this point the collapse in negotiations led to fears that there would need to be a second reading in Parliament meaning the Regulation's approval would be further delayed.

Finally however, after more than a year of protracted and highly politicised negotiations, a deal was struck in October 2011 to effectively ban naked sovereign CDSs. The countries that were opposed to it eventually agreed after an opt-out was included if the ban was damaging the sovereign debt markets.¹⁶⁷ The Parliament was also forced to dilute the strict restrictions that it and the Commission had pushed for on naked short sales, and agreed to the Council's more nuanced approach to such restrictions.¹⁶⁸ Further, the Member States also refused to also grant ESMA the same direct intervention powers with respect to the sovereign debt markets as it had in relation to other financial instruments, given the potential impact on a country's borrowing costs.¹⁶⁹ ESMA's other powers were preserved in the final rules, however its direct intervention powers continued to be controversial and were subsequently subject to an, ultimately unsuccessful, UK challenge at the ECJ that we will analyse further in Chapter 4.

¹⁶⁶ 'EU Short-Selling Talks Collapse Amid Sovereign Debt Fears' (n 151).

¹⁶⁷ Indeed the UK was still opposed to the bans but was out-voted, see e.g. Helia Ebrahimi, 'EU Set to Ban Insurance on Sovereign Bonds' *The Telegraph* (18 October 2011).

¹⁶⁸ As we have already observed, the Council proposed this dilution as far back as February 2011, see e.g. AIMA (n 153) Appendix.

¹⁶⁹ Moloney, *EU Securities and Financial Markets Regulation* (n 32) 568-9.

The Parliament voted the rules into law in November 2011 and the Council adopted the Regulation in February 2012.¹⁷⁰ The Rapporteur welcomed the result, stating that the rules proved that the EU could act against speculation when the political will was there and would make it impossible to buy CDS for the sole purpose of speculating on a country's default.¹⁷¹ However the UK's MEP stated that it was a short-sighted move 'driven by politics rather than sound economics'.¹⁷²

3.5 Assessment

Following more than a year's political wrangling, and many power struggles both in and between the EU institutions, the Regulation eventually contained one locate rule restricting the naked short selling of securities, and a second set of lighter restrictions, which also enabled temporary opt-outs, on the naked short selling of sovereign debt.¹⁷³ Separate provisions then banned sovereign naked CDSs, again permitting opt-outs if the bans were damaging the government debt markets.¹⁷⁴ Notably, these final rules were of a far more interventionist nature than the Commission's initial

¹⁷⁰ See European Parliament (n 5); Council of the European Union, 'Regulation Adopted on Short Selling and Credit Default Swaps' 21 February 2012 <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/128081.pdf> accessed 23 August 2013.

¹⁷¹ See European Parliament (n 5).

¹⁷² European Conservatives and Reformists Group, '*Short-Sighted' Short Selling Ban Adopted by MEPs* (15 November 2011).

¹⁷³ Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, arts 12-13.

¹⁷⁴ *Ibid* art 14.

Proposal, and the Parliament and Council's major and highly sensitive amendments were also not subject to further impact assessment.¹⁷⁵

Essentially, the desire to restrict naked short selling reflected unfounded concerns that naked short selling was a malicious type of speculation that could endanger a financial system's and an economy's stability. Although the eleventh hour retreat from the hard locate rule for shares by the Parliament was relevant for it politically, Chapter 4 will explore whether this actually makes a meaningful difference in practice.

Further, as already observed, there was also no legal or economic justification behind the differential approach taken to the regulation of the short selling of shares and sovereign debt: this was only due to the greater political sensitivities surrounding the possible damage to Member States' sovereign debt markets. Equally, the effective ban on naked sovereign CDSs was the culmination of a campaign pursued relentlessly by the Parliament in conjunction with particular Member States, rather than a decision based on a careful consideration of all the economic evidence. Indeed some MEPs were even subsequently quoted as saying that it was particularly 'en vogue' to be against speculation and that the 'inefficacy of regulation came a distant second to political point scoring'.¹⁷⁶

Ultimately the final set of rules should not have been dictated, or influenced, by political demands and agendas. A combination of tense relations within and between the EU institutions, uneasy political compromises, a lack of concrete

¹⁷⁵ Moloney, *EU Securities and Financial Markets Regulation* (n 32) 548.

¹⁷⁶ 'Banning Naked Short-Selling Won't Solve the Eurozone Crisis' (n 85) 1-2.

empirical evidence (especially with respect to the sovereign debt markets) and a crisis induced sense of urgency, was never going to be a good formula for producing carefully crafted, measured legislation aimed at addressing specific problems.¹⁷⁷ Even if some harmonisation of short selling rules may have been desirable, rushed policy decisions stemming from short term political reasoning was not the way forward.

Perhaps a more multi-staged legislative procedure, in conjunction with a lengthier pre-proposal consultation, could have helped provide more of a challenge, or at the very least introduced a brake in the overall process. Certainly, as we already observed, there was talk of the Proposal having to go back to the Parliament for a second reading in September 2011 when the trialogue negotiations kept collapsing. Such an approach may have helped protect against such a hastily produced final text, especially given the complexity of the issues being debated.¹⁷⁸

Separately, the Parliament's significant role in crafting the shape of the final rules should also be noted, a performance that has not been limited to short selling rules.¹⁷⁹ Indeed in the post-crisis landscape, it is the Parliament that has emerged as the European institution with its reputation most enhanced for effectiveness in

¹⁷⁷ Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' (n 20) 397. It should also be noted that there are considerable similarities behind these negotiations and the introduction of the Financial Transaction Tax ('FTT'), including the proposal not being supported by evidence put forward in the FTT's Impact Assessment, Franco-German and Parliament involvement, Member States holding divergent views, and concerns being raised about the proposal from market participants, academics, and others. See e.g. John Vella, 'Regulatory Choice: Observations on the Recent Experience with Corrective Taxes in the Financial Sector' in Wolf-Georg Ringe and Peter M Huber (eds), *Legal Challenges Arising out of the Global Financial Crisis: The Euro, Bail-Outs, and Regulation* (Hart Publishing 2012).

¹⁷⁸ See Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (n 1) 1339.

¹⁷⁹ Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' (n 20) 414.

securing its own priorities.¹⁸⁰ However, whether the Parliament's political priorities correspond to carefully considered, well balanced choices which address both the risks and uncertainties that exist in financial markets, and also ensure that the many benefits short sellers bring to markets are preserved is far less likely.¹⁸¹

Turning to then evaluate the divergence between the US and EU's approach to short selling regulation, as explored above, the political drivers varied considerably on both sides of the Atlantic. Although there was no push to regulate the short selling of sovereign debt in the US, instead there was considerable political pressure from Congress to re-regulate the short selling of securities following the financial crisis. Combined with a considerably weakened SEC and a highly disgruntled public, this led to the adoption of a populist naked short selling anti-fraud rule, and the reintroduction of a type of tick test.

This divergence in approach to regulation in the EU and US (a point that will be explored further in subsequent Chapters) means there continues to be a lack of global harmonisation of short selling rules, a concern highlighted by IOSCO and a situation that should be of concern in our increasingly international, interconnected markets. Indeed, when different political priorities lead to jurisdictions going their own way, the global marketplace has no choice but to cope the best it can with

¹⁸⁰ Ibid 414. Ferran highlights that the Parliament adopted a more nuanced approach with respect to the progress of the AIFMD but, interestingly, it also then succeeded in securing significant restrictions that were more intense than the Commission's starting position. Ferran notes that this confirms the Parliament's ascendancy both in broadly shaping of policy and in the specific content of laws, see further ibid 413-414. Also see Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (n 1) 1138-38 where Moloney highlights the confidence of the Parliament and states that its 'pro-regulation stance is likely to influence EU financial market law for some time'.

¹⁸¹ Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' (n 20) 414.

inconsistent regulations: IOSCO does not have the clout to impose an approach on jurisdictions that choose to tackle problems differently.¹⁸²

3.6 Conclusion

This Chapter has considered the importance of political economy, rather than economic literature, in shaping the final European short selling rules: a swift reaction to the sovereign debt crisis that led to the scapegoating of short sellers. Short sellers were not the cause of the debt crisis, yet it was far easier for politicians to embark on a blame game, than to face up to the real problems facing the EU. Further, the particular focus of the Regulation on restricting naked short sales, including sovereign debt and sovereign CDSs also demonstrated the strong political steer deriving from Germany and France, driven by their own political interests, reinforced by the support of many MEPs.¹⁸³ As a result, short sellers are now subject to complex, potentially error-prone rules that pay little heed to the findings in the economic literature.

Perhaps the EU should have had the ‘courage to do almost nothing’.¹⁸⁴ This would have been more sensible, given the absence of adequate challenges or brakes in the overall legislative process, plus the fact that any rules adopted would be unlikely to be the ones needed to prevent the next crisis. However given that this was likely to be politically a non-starter, a viable, second-best alternative may have been what

¹⁸² Karmel (n 37) 883.

¹⁸³ Moloney, ‘EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?’ (n 1) 1372.

¹⁸⁴ Gerard Hertig, ‘Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective’ (2004) <http://ecgi.org/tcgd/launch/hertig_speech.php> accessed 20 August 2013; Enriques (n 28) 1153.

Enriques has termed ‘fare ammunia’ whereby regulators make a lot of noise and demonstrate a lot of activism but all the while produce very little change.¹⁸⁵

Bearing these issues in mind, we will now turn from the politicised negotiations behind the Regulation’s introduction to consider the precise regulatory tools that now regulate short selling in the EU and the US. Specifically, Chapter 4 will explore the restrictions imposed on the short selling of securities, and also the related, controversial intervention powers of ESMA.

¹⁸⁵ Enriques (n 28) 1154. Enriques notes that fare ammunia related to the conduct of sailors of the Royal Navy of the Kingdom of the two Sicilies in the 19th Century when the Highest Authorities of the Kingdom visited their ships, and translates it as moving ‘noisily around’. See *ibid* Appendix.

Chapter 4: Short Selling Constraints: A Ban on Naked Short Selling?

4.1 Introduction

Chapter 4 explores the permanent and temporary constraints introduced on the short selling of securities in the EU, and uses the US restrictions as a counterpoint to comment more effectively on the EU provisions. Chapter 2 demonstrated that short selling constraints are generally unhelpful and may be detrimental to the functioning of markets. Chapter 3 then illustrated that the shape of the final rules was dictated particularly by the tense political climate surrounding the sovereign debt crisis. Ultimately the politicisation of the process has resulted in a complex final set of rules that reflect, amongst other issues, the European Parliament's (the 'Parliament's) concern to ban naked short selling.

This Chapter suggests that the EU's permanent short sale restrictions are tantamount to a ban on naked short selling, particularly due to ESMA's strict interpretation of the related technical rules. Such heavy-handed rules constitute a considerable burden on short sellers, come at the expense of market efficiency, and should be viewed with considerable scepticism. Turning to the US, although the approach taken to permanent short selling restrictions has varied across the Atlantic, the end result has been largely the same: a de facto ban on naked short selling.

The Chapter also suggests that the EU temporary restrictions are a consequence of the unfounded concerns of regulators in relation to the negative effects of short selling during the crisis. Nevertheless the EU temporary restrictions do not go as far as the US restrictions where (as observed in Chapter 3) a type of price test has recently been reintroduced and the decision not to include such a test in the EU rules should be welcomed. The Chapter also analyses the new and controversial direct intervention powers of ESMA that were recently the subject of an unsuccessful challenge at the ECJ. It suggests that although there may be merit in having a coordinated cross-border response in the event that short selling restrictions are imposed, it should nevertheless be questioned whether short selling was a sensible model to take more general decisions concerning the future centralisation of powers in ESMA.¹

4.2 EU Short Selling Regulation

This section examines the permanent restrictions on the short selling of securities in the Regulation. It provides an overview of the relevant restrictions and also discusses ESMA and the Commission's recent evaluation of the rules. It suggests that although the final short selling restrictions are promoted as being less onerous than those first proposed by the Commission, they are in practice equivalent to a ban.

This section also discusses the Regulation's settlement obligations whose function is to tackle the risk of settlement failure that arises particularly with naked

¹ Matteo Gargantini, 'The ESMA Decision: Implications for the Governance of ESAs' (Conference on the Landmark 2014 ESMA decision of the ECJ, Luxembourg, 27 March 2014).

short selling through the imposition of strict settlement requirements and penalties for failures to deliver shares. It is important to recognise however that these requirements are in the process of being repealed and replaced by the EU Regulation on securities settlement and central securities depositories (the ‘CSD Regulation’).² The CSD Regulation has a wider scope than the Regulation and, amongst other aims, seeks to align settlement periods across the EU. Although it should improve overall levels of settlement discipline, many of the technical nuts and bolts are still under consideration. For instance, the CSD Regulation provides little guidance on how to calculate late settlement penalties and the relevant administrative rules are not expected until later in 2015.

4.2.1 Naked Short Sale Constraints on Securities: the Regulation

The EU has not opted for a ban on all types of short selling and there are no permanent restrictions on covered short sales in the Regulation. The Regulation differentiates between the two types of short selling and its primary focus is on restricting naked short selling. As observed in Chapter 3, the decision to restrict the naked short selling of shares, sovereign debt, and naked sovereign CDSs stemmed from the highly politicised negotiations surrounding the sovereign debt crisis. In particular, the resulting framework was dictated by the strong political steer coming from countries such as France and Germany, reinforced by the Parliament.

As discussed in Chapter 3, despite acknowledging the lack of evidence of risks of short selling and naked short selling, the Commission’s proposal introduced a rigid

² Regulation (EU) No 909/2014 of 23 July 2014 on Improving Securities Settlement in the European Union and on Central Securities Depositories and Amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 [2014] OJ L257/1.

‘locate and reserve’ rule. This required short sellers to have borrowed shares, to have entered into an agreement to borrow shares, or have an arrangement with a third party under which that third party had confirmed the shares had been ‘located and reserved’ for lending.³ This was a clear ban on naked short selling. Although the Parliament was also in favour of this rule, as part of the political trade-off involved for obtaining its ban on naked sovereign CDSs, it was forced to pull back from this. Thus the requirement was diluted and replaced with the lesser requirement that the short seller had located and had a ‘reasonable expectation’ of being able to borrow the shares from the located party so that settlement could be effected when due. However, although the dilution of the locate requirement was important politically, the amended rules still amount to a de facto ban.

4.2.1.1 Restrictions on Uncovered Short Sales in Shares

As we will observe at section 4.3 below, the EU permanent restrictions on short sales of shares were in part based on the US regulatory framework, as well as existing market practice.⁴ Turning to examine specifically article 12(1)’s wording, it applies to all short sales of shares within the Regulation’s ambit (although the wording of the ‘short sale’ definition restricts article 12 to ‘direct’ short sales and does not therefore also encompass ‘synthetic’ short sales through the use of derivatives).⁵ Article 12 distinguishes between covered and uncovered short sales and provides that a natural or legal person may enter into a short sale of a share admitted to trading on a trading

³ Commission Proposal for a Regulation on Short Selling and Certain Aspects of Credit Default Swaps COM(2010) 482, art 12.

⁴ Commission, ‘Short Selling: Technical Standards – Frequently Asked Questions’ (2012) 2-3.

⁵ See ‘short sale’ definition in article 2 of the Regulation.

venue⁶ when it is regarded as ‘covered’. This requires one of three conditions under article 12 to be met.

4.2.1.2 Article 12(1)(a) and (b): Borrowing Agreements

Article 12(1)(a)’s application is clear: a short sale is regarded as covered where the person has borrowed the share or made alternative provisions resulting in similar legal effect. Alternatively under article 12(1)(b), a short sale is regarded as covered if the person has entered into an agreement to borrow the share or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so settlement can be effected when it is due.

Implementing Regulation 827/2012 (the ‘Implementing Regulation’)⁷ elaborates on the types of agreements contemplated under art 12(1)(b),⁸ including futures, options, and repurchase agreements. Securities lending and prime brokerage agreements and arrangements,⁹ are also capable of falling within art 12(1)(b), but only if they are specific as to the number of shares to be sold short and specify a delivery

⁶ ‘Trading venue’ is defined as a regulated market or multilateral trading facility (‘MTF’), Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, art 2(1).

⁷ The Implementing Regulation is part of a package of four supporting implementing or delegated regulations, which flesh out the technical details of the Regulation.

⁸ Commission Implementing Regulation (EU) 827/2012 of 29 June 2012 Laying Down Implementing Technical Standards with Regard to the Means for Public Disclosure of Net Position in Shares, the Format of the Information to Be Provided to ESMA in Relation to Net Short Positions, the Types of Agreements, Arrangements and Measures to Adequately Ensure That Shares or Sovereign Debt Instruments Are Available for Settlement and the Dates and Period for the Determination of the Principal Venue for a Share According to Regulation No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L251/11, art 5(1).

⁹ For example used commonly by hedge funds to borrow securities from their prime broker.

date.¹⁰ For instance, a standard form master lending agreement covering a long time frame in relation to a wide range of securities, that is drawn on when required, would not of itself suffice to disapply the prohibition, unless complemented for each short sale with, for example, a confirmation containing a specific number of a security and a defined delivery date.¹¹

4.2.1.3 Article 12(1)(c): Locate Rule

Moving to article 12(1)(c), during the negotiations, this was the ‘much fought over’ locate requirement.¹² It provides a short sale will be covered where a person has an arrangement with a third party under which the third party has confirmed the share has been located, and has taken measures vis-à-vis third parties necessary for the person to have a ‘reasonable expectation’ that settlement can be effected when due.

Article 12(1)(c) provides for a two-step process: a locate requirement, plus measures that give rise to a reasonable expectation that settlement can be effected when due.¹³ Considering the locate requirement, this is required in all cases before a short sale of shares can be undertaken.¹⁴ The Regulation’s recitals and the

¹⁰ Implementing Regulation 827/2012 art 5(1)(f).

¹¹ ESMA, ‘Draft Technical Standards on the EU Short Selling Regulation: Final Report’ (March 2012) 6.

¹² Indeed during a workshop between national regulators and the Commission there was considerable disagreement as to whether there should be regulation of naked short sales (with views ranging from imposing a total ban to only tightening of settlement rules), and also how any locate rule should be framed, see European Commission, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps SEC(2010) 1055, Annex 4.

¹³ Although ESMA notes that there is nothing in practice to preclude the two steps being taken simultaneously, see ESMA, ‘Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper’ (January 2012) 11.

¹⁴ ESMA, ‘Draft Technical Standards on the EU Short Selling Regulation: Final Report’ (n 11) 6.

Implementing Regulation state that this confirmation relates to the third party's (e.g. the broker's) assessment that it considers it can make the shares available for settlement in due time. It takes into account the amount of the possible sale and market conditions, and indicates the period for which the shares are located.¹⁵ However the locate requirement does not necessarily imply the shares are already available to the third party at the time of the locate confirmation.¹⁶

In order to give the locate confirmation, measures must be taken vis-à-vis third parties for the short seller to have a reasonable expectation that settlement can be effected when it is due.¹⁷ Under article 12(2) of the Regulation, there are two main factors for ESMA to consider in determining what measures are necessary: intraday trading (i.e. short sales covered by purchases during the same day), and the liquidity of the shares.¹⁸ Consequently the Implementing Regulation provides for three different mechanisms: an intraday locate 'confirmation arrangement and measure'; a liquid shares confirmation arrangement and measure; and a more stringent 'standard' set of arrangements for all other short sales of shares.¹⁹

For intraday short selling, such arrangements include a confirmation by the third party, prior to the short sale being entered, that it considers the share to be 'easy

¹⁵ Regulation 236/2012, para 19; Implementing Regulation 827/2012, art 6(2)(a).

¹⁶ See ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper' (n 13) 11.

¹⁷ Regulation 236/2012 recitals, para 19.

¹⁸ ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper' (n 13) 11.

¹⁹ Implementing Regulation 827/2012, art 6(2)-(4). See also ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper' (n 13) 11.

to borrow' or purchase.²⁰ This includes specifying the share is easy to borrow in the relevant quantity taking into account the market conditions and other information available to the third party on the supply of shares. The Implementing Regulation also obliges the investor to confirm that the short sale will be covered by purchases during the same day.²¹ Similarly, for liquid shares,²² the arrangements include the confirmation, prior to the short sale being entered into, that the share is easy to borrow or purchase in the prevailing market conditions.²³ ESMA also notes that it is not sufficient to simply rely on or refer to an easy to borrow list: a prior confirmation is required.²⁴ Thus, short sellers cannot rely on industry-generated lists.

ESMA also confirmed that if the prior confirmation can be provided for liquid shares and intraday short selling that the share is easy to borrow or purchase in the relevant quantity, taking into account market conditions and other information available to the third party on the supply of the shares, then the share need not also be put on hold.²⁵ However, where this confirmation cannot be obtained, and for all cases where the short sale concerns an illiquid share, and where the short selling is for

²⁰ Regulation 236/2012 recitals para 19. See also ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper' (n 13) 12.

²¹ Implementing Regulation 827/2012, arts 6(3)(a) and (c). Note that article 6(3)(d) also requires the short seller to monitor the amount of the short sale not covered by purchases. Plus, if the short seller risks not being able to deliver, he must give an instruction to the broker to buy the shares needed to cover the short sale, see art 6(3)(e). See further ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper' (n 13) 12.

²² Note that with respect to the definition of 'liquid shares' set out in Implementing Regulation 827/2012, ESMA took the view that the Markets in Financial Instruments Directive 2004/39 ('MiFID') definition might be too limited and it widened the scope of article 6(4) to encompass other shares under certain conditions, such as when the shares are included in a main national index.

²³ Ibid art 6(4)(b). Article 6(4) also provides that the short seller must give the broker a commitment that he will give him an instruction to buy or borrow the shares needed to cover the short sale if it transpires he is not able to buy them in the market, see further art 6(4)(c). See also ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper' (n 13) 12.

²⁴ ESMA, 'Questions and Answers: Implementation of the Regulation on Short Selling and Credit Default Swaps (2nd Update) 2013/159' (January 2013) 25.

²⁵ ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Final Report' (n 11) 6; Implementing Regulation 827/2012, art 6(3)(c) and art 6(4)(b).

longer than an intra-day period, then the more stringent conditions apply and the shares must be at least ‘put on hold’.²⁶

4.2.1.4 Third Party

The third party (such as a broker) with whom the locate arrangements are made under article 12(1)(c) must be one of the types set out in article 8 of the Implementing Regulation.²⁷ ESMA also confirmed that, as a matter of legal interpretation, the third party that any arrangement is made with should be a distinct legal entity from the short seller. So, for example, a proprietary trading desk could not obtain cover for a short sale from another internal desk in the same investment firm in charge of securities lending or borrowing.²⁸ Article 8 also specifies the requirements that the third party must meet.²⁹

4.2.1.5 Limited Exemption: Market-Makers

²⁶ Implementing Regulation 827/2012, art 6(2). See also ESMA, ‘Draft Technical Standards on the EU Short Selling Regulation: Final Report’ (n 11) 7. Thus in such situations the seller will need to have a confirmation from the third party that it has at least put on hold the requested number of shares for that person.

²⁷ This includes investment firms, central counterparties, and central banks. Other entities such as pension funds, insurance companies, and credit institutions, whose activities are not primarily linked to the securities business, are also covered under article 8 provided they meet the article’s criteria.

²⁸ ESMA, ‘Draft Technical Standards on the EU Short Selling Regulation: Consultation Paper’ (n 13) 11. However see also section 4.2.2 below for ESMA’s proposals in relation to amending this requirement.

²⁹ Implementing Regulation 827/2012, art 8(2). Such requirements are participating in the management of borrowing or purchasing relevant shares, providing evidence of such participation, and being able, on request, to provide evidence of its ability to deliver. All such agreements, arrangements, confirmations, and instructions must also be provided in a ‘durable medium’ (i.e. in hard copy or capable of being printed) by the third party to the short seller as evidence of the existence of the relevant arrangement.

The Regulation also provides a limited exemption from the restrictions for bona fide market-making activities of market makers satisfying certain criteria.³⁰ Market making-activities include the activities of, amongst others, investment firms, and credit institutions that are members of a trading venue where the entity deals as principal in a financial instrument and acts in one of three capacities.³¹

ESMA has published guidelines on this exemption (the ‘Guidelines’) that NCAs and market participants must make ‘every effort’ to comply with,³² and the Guidelines emphasise the exemption only applies to transactions carried out in performance of market-making activities.³³ Market-making activity is determined on a financial instrument-by-instrument basis and is subject to various conditions, including a requirement for membership of the trading venue on which the instrument is admitted to trading.³⁴ A market-maker is required to notify its home NCA that it intends to make use of the exemption at least 30 calendar days before the first use of the exemption.³⁵ As we will observe below however, the authority of these Guidelines is called into question by various NCAs’ non-compliance with them.³⁶

³⁰ Regulation 236/2012, art 17. Note that authorised primary dealers are also exempt from the naked short selling restrictions if they are acting in relation to a buy-back programme or stabilisation regime, see further *ibid* art 17(4).

³¹ *Ibid* art 2(1)(k). The capacities are: (i) posting firm, simultaneous two-way quotes; (ii) fulfilling orders initiated by clients; and by (iii) hedging positions arising from (i) and (ii). Given the Regulation’s extra-territorial scope, the exemption also encompasses third country entities where the legal and supervisory framework of that third country has been declared equivalent by the Commission.

³² ESMA, ‘Exemption for Market Making Activities and Primary Market Operations under the EU Short Selling Regulation’ (April 2013) 3; Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 554.

³³ ESMA, ‘Exemption for Market Making Activities and Primary Market Operations under the EU Short Selling Regulation’ (n 32) 5. Recital 26 of the Regulation also notes that the exemption does not apply to proprietary trading.

³⁴ *Ibid* 33-34.

³⁵ Regulation 236/2012, art 17(5).

³⁶ Moloney (n 32) 554.

4.2.2 Evaluation

The EU has not opted for a ban on all types of short selling, and the absence of permanent restrictions on covered short sales should be supported. Next, the locate requirement is broadly in line with the high-level principles put forward by IOSCO who specifically noted that regulators could reinforce their regulatory regime by adopting other criteria including a locate requirement.³⁷ Further, as will be explored in section 4.3 below, the restrictions are based in part on the US restrictions, where a locate rule forms part of its regulatory set-up,³⁸ and this also helps introduce a degree of credibility to this aspect of the European rules.³⁹

Despite this however, the Regulation's restrictions should still be viewed with considerable misgiving. First, as observed in Chapter 2, short sale restrictions, whether on naked or all short sales, neither stabilise prices nor prevent price declines. Equally, Chapter 2 demonstrated that naked short selling was not a special case compared to conventional short selling, and that there were not essentially different arguments for its regulation from an economic perspective. Consequently, regulation stemming from unfounded political concerns in relation to the perils of naked short selling was never going to be a sensible approach for producing carefully crafted and thoughtfully considered rules.⁴⁰ More generally, as we also observed in Chapter 3, the decision to impose short selling restrictions also reinforced the development of a more

³⁷ IOSCO, 'Regulation of Short Selling, Final Report' (June 2009) 10.

³⁸ Notably however there are distinctions in relation to the precise parameters and interpretation of the rules in practice, for example the US enables the reliance on easy to borrow lists in contrast to the EU.

³⁹ Indeed this can also be contrasted with other aspects of the Regulation, including the CDS prohibition, which lacked empirical evidence aside from the German ban in May 2010. See also Moloney (n 32) 548.

⁴⁰ Eilís Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' (2011) 12 EBOR 379, 414.

interventionist approach to regulation, in contrast with the pre-crisis UK ‘disclosure-light touch’ attitude that was discredited by the financial crisis.

ESMA Evaluation

ESMA’s June 2013 evaluation of the Regulation (the ‘ESMA Evaluation’) further demonstrates that, despite an improvement in settlement performance since the Regulation’s introduction, this might have been achieved at some costs for the securities lending market and those using it.⁴¹ ESMA compared stocks affected by the Regulation with a control group of US stocks.⁴² ESMA demonstrated that activity in the securities lending market had been lower since the Regulation’s introduction, and that there was a significant reduction in lendable quantities and quantities on loan compared with a control group of US stocks. The effect was also more pronounced for stocks subject to the more stringent locate rule.⁴³

More generally, and in line with our findings in Chapter 2, ESMA also found that the restrictions had a negative effect on the price formation process: the speed of price discovery deteriorated further for EU stocks than for US stocks after the Regulation’s implementation.⁴⁴ Such findings were also reiterated in ESMA’s

⁴¹ ESMA also noted that the data did not cover all settlement fails as it only covered data collected from central counterparties, ESMA, ‘Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps’ (June 2013) 74.

⁴² A sample of 100 EU stocks was constructed from a set of 1000 stocks ranked by market capitalisation. ESMA randomly drew 25 shares from each quartile to embed shares with different liquidity characteristics and the same method was applied to 1000 US stocks.

⁴³ ESMA 21 (n 41) 72-3. ESMA compared the number of stocks on loan in the EU and US during 2012 and the first part of 2013. It did note that lendable quantities had seemed to recover since January 2013. It also found that the Regulation had no significant impact on the utilisation rate (the quantities of stocks on loan divided by lendable quantities).

⁴⁴ Ibid 68-9. ESMA used daily data over ten months (five before the Regulation’s implementation and five following its implementation). It computed a measure that proxied the speed of price discovery (a

qualitative responses⁴⁵ where it was observed that although there were some improvements in settlement performance, this might have been at the expense of efficient price formation and liquidity.⁴⁶ Separately however, ESMA's results came to no clear conclusion in relation to liquidity, and found that the volatility of returns of EU stocks decreased slightly compared with US stocks after the Regulation was implemented.

It should be observed that all ESMA's conclusions must be taken with a degree of caution.⁴⁷ The very short time frame between the Regulation's implementation and the publication of ESMA's Evaluation, plus the lack of data, makes it tricky to draw firm conclusions from these findings.⁴⁸ Indeed, the Commission in its subsequent report also concluded it was too early to make changes and it proposed a subsequent evaluation in three years time.⁴⁹ Nevertheless, ESMA's empirical analysis remains pertinent to this Chapter's discussion and the findings do suggest, largely in line with our findings in Chapter 2, that restrictions are adversely affecting the price discovery process.

measure of price delay) to assess the extent that past market-wide information mattered for the formation of prices once contemporaneous information was accounted for (i.e. in a perfectly efficient market, the inclusion of past market returns would not help explain contemporaneous stock returns better, thus the higher the price delay measure, the worse the price formation process).

⁴⁵ ESMA received 43 responses and 34 were publicly available on its website in English. Almost half of all the respondents were active in banking and investment services; and more than 15% were active in asset management and insurance and pensions. Entities active in the business of market infrastructure constituted almost 25%; and three respondents were professional associations. See *ibid* 8.

⁴⁶ *Ibid* 23. See further e.g. Winterflood Securities Ltd, *Call for Evidence* (15 March 2013) 3.

⁴⁷ ESMA also noted that regulatory data about securities lending was non-existent, so commercial data had to be used that may not be comprehensive enough. See further ESMA 21.

⁴⁸ *Ibid* 71. ESMA reiterated this point to the Commission. It also noted that the choice of control group could have an impact if the countries in the control group were not similar to the treatment group and had also been subject to regulations during the observation period. Indeed, as US stocks are also subject to various regulations, this could impact the findings.

⁴⁹ Commission, 'Report on the Evaluation of the Regulation on Short Selling and Certain Aspects of Credit Default Swaps' (December 2013) 8.

Significant Constraints

Turning to analyse the restrictions themselves, they are significant constraints on naked short selling, with only a limited, narrowly defined exception carved out for market-makers. Rather than for instance restricting their applicability to situations where naked short selling could potentially give rise to the greatest likelihood for abuse, the rules have a broad reach and apply to all shares within the Regulation's ambit, all of the time. Given the Commission acknowledged the many benefits short selling brings to markets, it would at least have been sensible to limit the application of the restrictions.

The constraints have also proven to be particularly onerous due to the strict interpretation ESMA has chosen to take of the technical rules. For instance, as observed, commonly used standard master lending agreements will be insufficient to satisfy article 12(1)(b) unless they include a specific confirmation covering specific securities and a specific delivery date for each short sale.⁵⁰

Further, the more stringent standard locate rule, which applies when shares are not easy to borrow, is a clear ban on naked short selling. This is evident from the put on hold confirmation that is necessary prior to commencing such a short sale. Additionally, it was suggested by some market participants that, due to stock lending facilities not being a feature in markets for smaller companies, the provisions

⁵⁰ Implementing Regulation 827/2012, art 5(1)(f). See also ESMA, 'Draft Technical Standards on the EU Short Selling Regulation: Final Report' (n 11) 6.

effectively banned all types of short selling in less liquid and smaller markets.⁵¹ Some also noted that more conservative approaches to securities lending had been adopted and that lending costs, especially for less liquid and smaller stocks, had increased or were likely to do so.⁵²

Turning to the rules for same day and liquid shares, although there is no put on hold confirmation required (provided the easy to borrow confirmation can be given) the rule remains a very serious constraint. Short sellers cannot simply rely on an easy to borrow list, they must obtain an actual confirmation from the broker that the share is easy to borrow prior to entering the short sale. Further the third party must also verify that the quantity of shares is easy to borrow taking into account market conditions. Additionally there are also extra confirmations and undertakings required that have been described by market participants as superfluous and counter-productive.⁵³

More generally, the locate rule's adverse effects were also reiterated by market participants. Concerns cited included increasing the costs for firms causing a reduction in client activity, leading to additional pressure in the lending market.⁵⁴ In particular the reduction in client activity suggests that some market participants may be refraining from short selling entirely or have engaged in regulatory arbitrage and shifted their activities to other unregulated means (including synthetic short sales) in

⁵¹ See e.g. comments of Winterflood Securities Ltd (n 46).

⁵² See e.g. Shore Capital Stockbrokers Ltd, *Call for Evidence* (15 March 2013) 2-3.

⁵³ For example for intraday short sales, there must be an undertaking by the short seller to continuously monitor the uncovered position, see Implementing Regulation 827/2012, art 6(3)(d). See also German Banking Industry Committee, *ESMA Call for Evidence* (15 March 2013).

⁵⁴ ESMA (n 41) 23.

order to fulfil their aims. Indeed, given that article 12 limits its ambit to direct short sales this is all the more likely.⁵⁵ The requirement to use a distinct legal entity to obtain the necessary locate arrangements and measures has also added layers of complexity, constrained operational processes, and had a negative effect on liquidity in the lending markets.⁵⁶

ESMA's restrictive interpretation of market-making activity has also been detrimental to liquidity provision.⁵⁷ Market participants highlighted concerns about the instrument-per-instrument approach, particularly in the light of the 30-day waiting period; the trading venue membership requirement, given this excluded OTC instruments and limited the ability to offer OTC market-making; and the administrative burden of the notification process.⁵⁸ Indeed, according to the ESMA Guidelines compliance table, five Member State NCAs (including the UK, Germany and France) have not complied with various aspects due to their divergent views on a number of issues.⁵⁹ Consequently the strength of this 'soft law' measure in the face of such non-compliance should be queried.⁶⁰

Assessment

⁵⁵ For further detailed discussion of this 'boundary' problem, see also e.g. Chapter 6, section 6.6.

⁵⁶ See ESMA (n 41) 23.

⁵⁷ Ibid 34.

⁵⁸ Ibid 34-35.

⁵⁹ These issues included the scope of financial instruments eligible for the exemption and the provisions requiring membership of a trading venue. See further ESMA, 'Market Making Guidelines Compliance Table' (19 June 2013) 8-9.

⁶⁰ Moloney (n 32) 554; 934.

It is the precise parameters of locate arrangements and measures that determine how close a set of rules come to constituting an absolute ban on naked short selling.⁶¹ Based on ESMA's narrow interpretation of permissible borrowing and locate arrangements, taken in conjunction with the particularly narrow confines of the market-making exemption, the overall effect of the rules is a de facto ban on naked short selling and this is a significant detriment to the functioning of efficient markets. Although the watering down of the hard locate and reserve provision was helpful to the Parliament in the political arena, it has not in fact amounted to meaningful change.

Invalidate or Alleviate the Negative Effects of the Ban?

In the absence of the naked short selling rules being removed in the near future however, there are a number of legal arguments that could be put forward to try and either invalidate the short selling ban, or at least limit its applicability. As these arguments are also relevant to the effective ban on naked sovereign CDSs, we will also reflect on these in Chapter 6.

First, and linked to one of the UK's arguments for challenging ESMA's intervention powers that will be discussed at section 4.4.3.1 below, market participants could contest the use of article 114 of the Treaty on the Functioning of the European Union ('TFEU') as the legal basis for adopting the ban. Specifically, article 114 ties legislative harmonisation to the establishment and functioning of the internal market and it is questionable at best whether a short selling ban facilitates the

⁶¹ See e.g. John Armour and others, *Principles of Financial Regulation (Draft Version)* (OUP forthcoming 2016) ch 8, 19.

fundamental freedoms and functioning of the internal market.⁶² Next, participants could also seek to challenge the Regulation as being ‘manifestly inappropriate’ in relation to the objective being pursued.⁶³ However this option may be somewhat ‘stacked against the applicant’⁶⁴ as the ECJ is reluctant to overturn policy choices of the administration, and the prior case law demonstrates it is tricky for applicants to succeed with such a claim.⁶⁵

Alternatively, and perhaps more realistically, in order to curtail the ban’s negative impact, participants could argue in favour of a narrow construction of the rules whenever there is any ambiguity in the drafting. Specifically, market participants could invoke the *contra proferentem* rule of interpretation. According to this principle, in the case of doubt as to a term’s meaning, the wording should be construed as narrowly as possible and against the party who proposed its inclusion. Consequently, in such a case the interpretation most favourable to a short seller should prevail.⁶⁶ So for instance, it could be argued that due to the ambiguities surrounding the precise meaning of locate arrangements, such measures should be

⁶² See Stefan Enchelmaier, ‘The Awkward Selling of a Good Idea, or a Traditionalist Interpretation of Keck’ (2003) 22 Yearbook of European Law 249, 307-8. However see also Stephen Weatherill, ‘The Limits of Legislative Harmonization Ten Years after Tobacco Advertising: How the Court’s Case Law Has Become a “Drafting Guide”’ (2011) 12 German LJ 827 who demonstrates how difficult it is in practice to annul such measures.

⁶³ Case C-331/88 *R v Minister for Agriculture, Fisheries and Food, Ex Parte Fedesa* [1990] ECR I-4023; Paul Craig, *EU Administrative Law* (2nd edn, OUP 2012) 595; 603-4.

⁶⁴ Paul Craig (n 63) 603.

⁶⁵ *Ibid* 593-604.

⁶⁶ Ewan Mckendrick, *Contract Law* (9th edn, Palgrave MacMillan 2011) 168. This is a widely accepted principle of interpretation that has its roots in Roman law and is already part of existing European law, see Hans Christoph Grigoleit and Claus-Wilhelm Canaris, ‘Interpretation of Contracts’ (January 2010) 15-6.

interpreted so as to permit reliance by short sellers, for example, on ‘easy to borrow’ lists for intraday trading and for liquid shares.⁶⁷

Finally, and on a much more practical level, given that article 12’s ambit is restricted to direct short sales, parties are likely to continue to work around the rules by engaging in regulatory arbitrage using synthetic equivalents.

4.2.3 Settlement Discipline

4.2.3.1 Article 15: Settlement Obligations

Turning to consider the Regulation’s settlement obligations, as observed in section 4.2 above, article 15 is in the process of being repealed and replaced by the CSD Regulation. Nonetheless it is relevant to briefly consider the Regulation’s provisions that seek to tackle the risk of settlement failure that can arise particularly from naked short selling, before noting the changes being introduced by the CSD Regulation.

As observed in Chapter 2, there is the potential in particular for naked short selling to disrupt the orderly functioning of market where the seller is unable or unwilling to deliver the shares in time for settlement. The Regulation’s settlement rules therefore set out basic standards relating to settlement discipline through a combination of buy-in procedures and fines for the failed settlement of transactions in shares. Article 15 states that central counterparties (‘CCPs’) in Member States that

⁶⁷ A related argument could be used to, for instance, enable the use of standardised prime brokerage or other similar arrangements, see e.g. AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (15 March 2013) 9.

provide clearing services for shares are to ensure procedures are in place so that where a person sells shares and is not able to deliver them for settlement within four business days after settlement is due, procedures are automatically triggered for the buy-in of shares to ensure delivery for settlement.⁶⁸ Where buy-in is not possible, an amount is to be paid to the buyer based on the value of the shares to be delivered at the delivery date plus an amount for losses incurred by the buyer due to settlement failure.⁶⁹ The person who fails to deliver is also to reimburse all such amounts paid.⁷⁰ Further, where a person fails to deliver for settlement on the date that settlement is due, the CCP is to ensure that the short seller makes daily, sufficiently high, payments for each day that the failure continues.⁷¹

The Regulation's buy-in provisions were the first attempt at EU-wide mandatory requirements on buy-in procedures and penalties for settlement discipline purposes.⁷² They have led to improvements, particularly due to market participants seeking to avoid penalties and the risk of enforced buy-in.⁷³ For instance it was noted by the leading European equity CCP that there has been a reduction in the UK of up to fifty per cent in the rate of transactions that failed to settle on the intended settlement date.⁷⁴ Despite this however, article 15 ambit is limited: it only covers shares cleared by a CCP, and such transactions already follow a strict buy-in regime.⁷⁵ In addition article 15 does not include OTC or exchange transactions not cleared by a

⁶⁸ Regulation 236/2012, art 15(1)(a).

⁶⁹ Ibid art 15(1)(b).

⁷⁰ Ibid art 15(1)(c).

⁷¹ Ibid art 15(2).

⁷² ESMA (n 41) 25.

⁷³ See e.g. Deutsche Bank, *ESMA Call for Evidence* (15 March 2013) 10.

⁷⁴ See LCH Clearnet, *ESMA Call for Evidence* (15 March 2013) 1.

⁷⁵ Deutsche Börse Group, *ESMA Call for Evidence* (15 March 2013) 2.

CCP and in some countries this constitutes a large part of the trading activity.⁷⁶ Further, the Regulation does not harmonise the length of the settlement periods throughout the EU, and the settlement penalties are also not harmonised, creating a risk of arbitrage.⁷⁷

4.2.3.2 CSD Regulation

ESMA acknowledged these limitations and considered that settlement discipline requirements could be more effectively and extensively tackled through a single piece of legislation.⁷⁸ The CSD Regulation largely came into effect during September 2014, although the introduction of the CSD settlement discipline provisions and the repeal of article 15 of the Regulation shall only apply from the date of entry into force of related delegated legislation (currently anticipated for mid-late 2015).⁷⁹

Amongst other issues the CSD Regulation harmonises the timing and conduct of securities settlement throughout the EU.⁸⁰ Specifically it aligns the settlement periods for transactions in transferable securities (broadly shares and bonds) executed on trading venues across the EU to T+2.⁸¹ Although OTC transactions are ‘out of scope’, best practice guidelines also support T+2 as the default rule for most OTC

⁷⁶ ESMA (n 41) 25. Indeed, the new rules created incentives to perform transactions OTC or on platforms without CCP clearing, see Deutsche Börse Group (n 75) 2.

⁷⁷ ESMA (n 41) 25; AFME and ISDA, *ESMA Call for Evidence* (15 March 2013) 14. For instance there could be a conscious decision to fail to a cheaper CCP to avoid a higher penalty at another CCP.

⁷⁸ ESMA (n 41) 25.

⁷⁹ CSD Regulation, recital 78; arts 72 and 76(5).

⁸⁰ Commission, ‘Regulation on Securities Settlement and on Central Securities Depositories in the EU (‘CSD Regulation’) – Frequently Asked Questions’ (2014) <<http://perma.cc/5SBR-REMX>> accessed 12 September 2014.

⁸¹ CSD Regulation, art 5(2).

transactions where the underlying is a transferable security in the scope of the CSD Regulation.⁸² Although the rules provide that the T+2 requirement will broadly applied from 1 January 2015, European markets migrated to T+2 on 6 October 2014.⁸³

The CSD Regulation also initiates mandatory buy-in periods where there is a FTD within four business days after the intended settlement date.⁸⁴ For financial instruments traded on small and medium sized enterprise ('SME') growth markets (a new concept introduced by MiFID II), the period for delivery is generally extended to fifteen days.⁸⁵ If buy-in is not possible, the receiving participant can choose whether to be paid cash compensation, or it can defer execution of the buy-in until an appropriate later date.⁸⁶

The CSDs (i.e. the main institutions that operate the infrastructure enabling settlement) are also required to establish procedures providing for penalties, including cash penalties, to serve as a deterrent for participants causing settlement fails.⁸⁷ These

⁸² See e.g. HSBC, *Client Guide: Derivatives and T+2* (September 2014)

⁸³ Deutsche Bank, *Central Securities Depository Regulation* (2014) 1-2; European Central Securities Depositories Association, *A Very Smooth Transition to T+2* (October 2014).

⁸⁴ CSD Regulation, art 7(3).

⁸⁵ Ibid art 7(3). This is unless the SME growth market decides to apply a shorter period.

⁸⁶ Ibid art 7(7). If the share is not delivered at the end of the deferred period, cash compensation will be paid. Note that under article 7(10) if the CCP clears the trade, it executes the buy-in. If it is not cleared by a CCP but is executed on a trading venue, the venue shall include obligations in its internal rules for its members and participants to apply the measures. For all other transactions (i.e. OTC transactions), the CSDs shall include an obligation in their internal rules.

⁸⁷ Ibid art 7(2). There are over thirty CSDs in Europe, generally one in each country, and two international CSDs specialising in issuing international bonds (Euroclear Bank and Clearstream Banking Luxembourg), see Commission, 'Regulation on Securities Settlement and on Central Securities Depositories in the EU ('CSD Regulation') – Frequently Asked Questions' (n 80) 1-2.

will be calculated on a daily basis for each business day a transaction fails to be settled after its intended settlement date until the end of the buy-in period.⁸⁸

4.2.3.3 Comments

The new harmonised settlement rules can be broadly welcomed. As we observed in Chapter 2, tackling such concerns with respect to short selling through a combination of tightened settlement periods, enforced buy-ins, plus the threat of daily penalties should help eliminate or reduce any incentive not to settle a trade. The degree of flexibility the CSD Regulation also introduces with respect to buy-ins of financial instruments traded on smaller markets also takes into account drawbacks with the Regulation's previous 'one size fits all' approach to settlement.⁸⁹ Likewise, the imposition of daily cash penalties where there are FTDs should also help provide incentives to ensure that securities are delivered on time.

However, many of the technical nuts and bolts of the CSD Regulation are still to be finalised. For instance the CSD Regulation provides little guidance on how to calculate late settlement penalties and it is unclear from its wording whether the penalties apply to transactions in all securities, or only liquid securities, or what formula CSDs must use to calculate a penalty fee.⁹⁰ Such issues will be expanded on in the regulatory technical standards, however these are not expected until the second

⁸⁸ CSD Regulation art 7(2). The Commission is to adopt delegated legislation specifying the parameters for calculating the penalties, see art 7(14).

⁸⁹ See e.g. Winterflood Securities Ltd (n 46) 5.

⁹⁰ Ceri Jones, *CSDs Battle Regulatory Timeline* (Euromoney Institutional Investor PLC August 2014) 2.

half of 2015, and there are also calls for this deadline to be further pushed back due to concerns the new regime cannot be implemented within the existing time frame.⁹¹

Likewise, there is also currently a lack of standardisation between CSDs with respect to penalties: some CSDs do not currently have a penalty fee regime in place, and the scope of existing regimes also varies between countries. In the UK for instance, settlement penalties only apply to FTSE 350 securities, whereas Sweden's penalty regime varies depending on whether instructions are equity related or concern a fixed income instrument.⁹² With this in mind, although the CSD Regulation's settlement provisions should ultimately improve overall settlement discipline within the EU going forward, it is clear that, in particular, the creation of a pan-European penalty regime is likely to be both a slow and challenging process.

4.3 US Short Selling Regulation: Permanent Constraints

4.3.1 Overview

In contrast to the EU, where short selling regulation was uncommon prior to the financial crisis, the US had regulated short selling in one form or another since the 1930s. This section focuses on the US permanent constraints on short sales and suggests that although the approach taken varies to an extent across the Atlantic, the end result is functionally equivalent: a de facto ban on naked short selling. Likewise, and in a similar vein to the EU, issues of political economy have also particularly

⁹¹ Ibid 1-2.

⁹² Ibid 2-3.

dictated the SEC's post-crisis attitude towards its short selling policy. Specifically, the SEC emerged from the crisis a much weaker body, and when considering the future direction of its short selling policy, it may well have been seeking to please the politicians who provided its funding.

This section considers the US restrictions on all short sales in relation to seasoned equity offerings ('SEOs'): rule 105 of Regulation M. It will be suggested that although, as observed in Chapter 2, there are concerns about manipulative short selling with respect to SEOs, this does not merit imposing permanent restrictions that also prevent legitimate short selling activity. The permanent restrictions on naked short sales will then be considered. In particular the US locate rule, the 'close out' requirements introduced to reduce FTDs, and the naked short selling anti-fraud rule (the 'anti-fraud' rule) will be discussed. It will be suggested that the combination of the locate rule, plus the FTD rules, preclude naked short selling, and that the anti-fraud rule neither substantively bolsters nor extends existing rules on either naked short selling or market manipulation. Indeed as observed in Chapter 3, it is likely that the anti-fraud rule's origin is more political than legal.⁹³ We will also consider the recent shift in the SEC's stance towards its short selling policy and it will be suggested that this is particularly a consequence of the political pressure placed on the SEC since the start of the crisis.

4.3.2 Regulation M: SEO Restrictions on Short Selling

⁹³ Seraina N. Grunewald, Alexander F. Wagner and Rolf H. Weber, 'Short Selling Regulation after the Financial Crisis: First Principles Revisited' (2011) 7 *International Journal of Disclosure and Governance* 108, 120.

As we observed in Chapter 2, the US restricts covered and naked short selling in the context of SEOs. Rule 105 of Regulation M governs short selling in connection with public offerings. Initially, rule 105 prohibited short sellers from covering their short position with shares purchased in a SEO if the short position was established in the five business days prior to the offer date.⁹⁴ However due to concerns about various violations, it was amended in 2007 to prohibit a person who opened a short position five business days prior to issuance, from purchasing shares in the offer, regardless of whether the shares would be used to cover the short sale.⁹⁵

As discussed in Chapter 2, although the empirical studies in this area provided a relatively mixed picture, a recent study by Autore and Gehy that focused on amended rule 105 found that the restrictions could reduce SEO pricing efficiency and have significant unintended consequences on the capital raising process.⁹⁶ Equally, a recent paper by Jones et al. found that price declines during rights issues were not due to manipulative short sales and that there was no need to ban shorting during such issuances.⁹⁷

In line with our conclusions in Chapter 2, concerns as to potentially abusive behaviour do not justify the imposition of such permanent restrictions that could also restrict legitimate short selling activity. Rather, a better approach would be to target all manipulative activity (involving long or short trading) through better enforcement

⁹⁴ SEC, 'Short Selling in Connection with a Public Offering (Final Rule) Release No. 34-56206' (6 August 2007) 2.

⁹⁵ Ibid 3.

⁹⁶ Don M. Autore and Dominique Gehy, 'Changing the Rules Again: Short Selling in Connection with Public Equity Offers' (2013) 37 *Journal of Banking & Finance* 1974.

⁹⁷ Charles Jones, Adam Reed and William Waller, 'Revealing Shorts: An Examination of Large Short Position Disclosures' (AFA 2013 San Diego Working Paper) 41. See also Appendix 3.

of existing market abuse regimes rather than through imposing restrictions on all short sales.⁹⁸

4.3.3 Regulation SHO: Constraints on Naked Short Selling

Turning to its regulation of naked short selling, the US already had a fairly hostile view of such activity well before the financial crisis. Regulation SHO, implemented in January 2005, and amended many times since, provided a regulatory framework for short sales and marked a significant shift in the SEC's approach to short selling regulation.⁹⁹ The SEC remarked that the current requirements imposed by self-regulatory organisations ('SROs')¹⁰⁰ had not fully addressed the problems of naked short selling and extended FTDs and that it would be beneficial to establish a uniform standard for all short sellers to locate securities for borrowing.¹⁰¹ Notably however, although the SEC recognised that there were a substantial number of economic arguments in favour of short selling, it chose to place no weight on these studies, or to take a view on them. This was disappointing: the SEC had its own Office of Economic Analysis capable of conducting independent analysis of economic studies

⁹⁸ For example in the US there is a general anti-fraud provision under rule 10b-5 aimed at eliminating fraud in the trade of securities. Further section 9(a)(2) Securities Exchange Act 1934 (the 'Exchange Act') provides that it is an offence to effect alone or with others, a series of transactions in any security registered on a national exchange, or not registered, creating actual or apparent active trading in such security, or raising or depressing the price of such a security, for the purpose of inducing the purchase or sale of such security by others.

⁹⁹ Katherine McGavin, 'Short Selling in a Financial Crisis: The Regulation of Short Sales in the United Kingdom and the United States' (2010) 30 *Nw J Int'l L & Bus* 201, 219.

¹⁰⁰ All securities exchanges in the US are SROs, as is the Financial Industry Regulatory Authority ('FINRA'), the successor to the National Association of Securities Dealers ('NASD'). FINRA is the largest independent regulator of securities firms conducting business in the US.

¹⁰¹ SEC, 'Short Sales, Release No. 34-48709 (Proposed Rule)' (October 28, 2003) 62976.

relating to short selling and expressing a view on whether it was beneficial or detrimental to the market.¹⁰²

4.3.3.1 Rule 203(b) Regulation SHO: Locate Rule

Rule 203(b) of Regulation SHO created a uniform SEC rule requiring broker-dealers, prior to effecting a short sale in an equity security, to locate securities available for borrowing. Specifically, brokers were placed in the ‘front line’ with respect to US short selling regulation and the rule prohibited broker-dealers from accepting a short sale order in a security from another person, or effecting a short sale order for the broker’s own account, unless the broker-dealer had either borrowed the security or entered into an arrangement to borrow the security, or had reasonable grounds to believe the security can be borrowed so that it could be delivered on the date delivery is due.¹⁰³ The locate had to be made and documented prior to effecting the short sale, regardless of whether the short seller’s position might be closed out by purchasing securities the same day.¹⁰⁴

The broker-dealer had the responsibility for performing the locate,¹⁰⁵ and what could constitute reasonable grounds was not specifically defined and was to be determined on the facts and circumstances of the particular transaction. However the

¹⁰² Ibid 62978; Steven Lofchie and Tal Tirosh, ‘How the SEC Plans to Curb Short Selling’ (2004) 23 IFL Rev 30, 32.

¹⁰³ SEC, ‘Short Sales, Release No. 34-50103 (Final Rule)’ (July 28, 2004) 48014.

¹⁰⁴ Ibid 48014. The rule 203(b)(1)(iii) requirement that the broker documents compliance with the reasonable grounds test only requires the broker to document that it is relying on the short seller’s assurance and that the broker has reasonable grounds to believe that the short seller has borrowed or arranged to borrow the shares. See further SEC, ‘Guidance Regarding the Commission’s Emergency Order Concerning Short Selling’ (18 July 2008) 1.

¹⁰⁵ SEC, ‘Short Sales, Release No. 34-50103 (Final Rule)’ 48014.

SEC stated that a broker-dealer could obtain an assurance from the short seller that it could obtain securities from another identified source in time to settle the trade and this could provide the reasonable grounds required by rule 203(b)(1)(ii).¹⁰⁶

Notably, the SEC considered that, absent countervailing factors, easy to borrow lists could provide reasonable grounds for a broker-dealer to believe that the security sold short was available for borrowing without directly contacting the source of the borrowed securities.¹⁰⁷ However, the information used to generate the list had to be less than 24 hours old, and securities on the list had to be readily available such that it would be unlikely that a FTD would occur.¹⁰⁸ Thus, in contrast to the EU provisions, rule 203(b) allowed a short seller to satisfy the reasonable grounds test without having to supply evidence of a firm arrangement to borrow the shares ahead of settlement.¹⁰⁹

4.3.3.2 Exceptions

Rule 203(b)(2)(i) provided for an exception for a registered broker or dealer that received a short sale order from another registered broker or dealer required to comply with rule 203(b)(1). A second exception related to market-makers engaged in bona-fide market making activities.¹¹⁰ A further exception applied where a broker-

¹⁰⁶ Ibid 48014.

¹⁰⁷ Ibid 48014.

¹⁰⁸ Ibid 48014.

¹⁰⁹ Paul Ali, 'Short Selling and Securities Lending in the Midst of Falling and Volatile Markets' (2008) 24 *Journal of International Banking Law and Regulation* 1, 5.

¹¹⁰ Regulation SHO, rule 203(b)(2)(iii). This did not include activity related to speculative selling strategies or investment purposes of the broker-dealer and that was disproportionate to the usual market making patterns of the broker-dealer in that security.

dealer effected a sale on behalf of a customer who was deemed to own the security pursuant to rule 200,¹¹¹ but through no fault of the broker-dealer or the customer, did not expect the security to be in the broker-dealer's possession by the delivery date.¹¹²

4.3.3.3 Short Sales in Threshold Securities

At the same time, the SEC also decided to adopt rules designed to reduce FTDs by imposing additional delivery requirements on securities with substantial amount of FTDs.¹¹³ Rule 203(b)(3) placed close out requirements on participants of registered clearing agencies (which include broker-dealers) in relation to equity securities with a large and persistent level of fails, known as 'threshold securities'. This was a security with respect to which there was an aggregate FTD for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, equalled at least 0.5% of the issuer's outstanding shares, and was included on a list disseminated by a SRO.¹¹⁴ If a participant had a FTD in a threshold security for 13 consecutive days, then until it was closed out, participants, and broker-dealers that participants cleared transactions for, could not effect a short sale without complying with the 'pre-borrowing' requirement.¹¹⁵

¹¹¹ Rule 200 sets out when a person is deemed to own a security, including where he or his agent has title to the security.

¹¹² Regulation SHO, rule 203(b)(2)(ii). In addition, the SEC also reserved discretionary power to exempt people, transactions, and practices from the rules without public disclosure, see rule 200(h); SEC, 'Short Sales, Release No. 34-50103 (Final Rule)' (n 103) 48030.

¹¹³ In the US, trades are generally settled on T+3, and if not fulfilled, it becomes a FTD.

¹¹⁴ SEC, 'Short Sales, Release No. 34-50103 (Final Rule)' (n 103) 48016. Similarly, in order to be removed from the list of threshold securities, a security must not exceed the specified level of FTDs for five consecutive days.

¹¹⁵ Some suggested that the effectiveness of this rule was reduced by the existence of the broker-to-broker exception under rule 203(b)(2)(i). For example if the brokers traded back and forwards between themselves, the 13 day clock would restart each time Alexis Brown Stokes, 'In Pursuit of the Naked Short' (2009) 5 NYU J L & Bus 1, 47. Exceptions were initially included relating to FTDs established

4.3.3.4 Post-Crisis Rules to Reduce FTDs: Rule 204 Regulation SHO

As we observed in Chapter 3, in contrast to the EU where the sovereign debt crisis was the catalyst for the Regulation's introduction, the financial crisis provided the main stimulus for regulatory overhaul in the US. Although, short selling regulation did not dominate the US post-crisis regulatory agenda as much as some other issues (that included, for instance increasing the transparency of derivatives), this period nevertheless led to the uniform tightening of restrictions on short selling.¹¹⁶ Specifically, the SEC embarked on a period of intensive rule making that stemmed from 2008 through to the middle of 2009 and beyond. For instance, between July 2008 and April 2009 the SEC took more than fifteen regulatory actions with respect to short selling and many of the rules were adopted using emergency orders without the normal 'public notice and comment' process.¹¹⁷

Further, its regulatory policy also expanded to cover both the FTD and price test branch of restrictions.¹¹⁸ The price test avenue will be considered in section 4.5 below, but of particular relevance to this section is the SEC's introduction of tighter rules for FTDs in the form of permanent rule 204 Regulation SHO in 2009: a far reaching step that, in conjunction with the locate rule, constitutes a de facto ban on naked short selling. Similarly, the introduction of the anti-fraud rule in 2008 is also

prior to a security becoming a threshold security (the 'grandfather' exception) and for registered options market makers but these were eliminated over time.

¹¹⁶ Erik R. Sirri, 'Regulatory Politics and Short Selling' (2010) 71 University of Pittsburgh Law Review 517, 531.

¹¹⁷ Henry T. C. Hu, 'Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm' (2012) 90 Tex L Rev 1601, 1694.

¹¹⁸ Sirri (n 116) 525.

particularly illustrative of the political climate surrounding the crisis and populist perceptions that existed concerning naked short selling.

NSCC Automatic Procedures

Although the SEC's move to remove FTDs was linked to a belief that shares that FTDs have an impact on liquidity and pricing efficiency different from shares that deliver,¹¹⁹ as we observed in Chapter 2 economically this is not the case. Specifically the effect of a short sale on market quality does not depend on whether or not the short sale results in timely delivery at settlement.¹²⁰ Next, when considering the systems in place for resolving FTDs in the US,¹²¹ the National Securities Clearing Corporation ('NSCC')¹²² has an automatic process for tackling FTDs. If the selling member's stock account has enough shares in its account, the NSCC uses these shares.¹²³ If not, the NSCC can use its stock borrow program whereby NSCC members can opt to lend NSCC available stocks to cover temporary shortfalls.¹²⁴ In line with the EU settlement rules the long member can also initiate a buy-in and the

¹¹⁹ See SEC, 'Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58572' (17 September 2008); Veljko Fotak, Vikas Raman and Pradeep K. Yadav, 'Fails-to-Deliver, Short Selling, and Market Quality' (2014) 114 *Journal of Financial Economics* 493, 495.

¹²⁰ Fotak, Raman and Yadav (n 119) 515.

¹²¹ It should be noted that the following analysis draws particularly on the analysis of clearing and systems to tackle FTDs in Christopher L. Culp and J. B. Heaton, 'The Economics of Naked Short Selling' (2008) 31 *Regulation* 46.

¹²² Ibid 49. Note that the NSCC acts as the central counterparty for the clearance and settlement of virtually all broker-to-broker equity (and corporate and municipal bond and unit investment) trading in the US. Through the continuous net settlement ('CNS') system, the NSCC settles trades from the exchanges, markets, and other sources and nets these transactions. See DTCC, 'Continuous Net Settlement System and the NSCC' (2014) <<http://www.dtcc.com/clearing-services/equities-clearing-services/cns.aspx> (<http://perma.cc/B5R8-CZKJ>)> accessed 8 October 2014; SEC, 'FAQs on Regulation SHO' (2012) <<http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (<http://perma.cc/VFP2-F4MN>)> accessed 9 June 2014.

¹²³ Culp and Heaton (n 121) 50.

¹²⁴ Ibid 50. Note however that shares are often unavailable for those most popular with short sellers.

selling member then has another period of time (generally two days) to deliver the shares, otherwise the NSCC can buy the shares and charge the account of the seller. While the position remains open the seller will not receive the funds and the buyer can earn interest on the proceeds of the payment he retains until delivery.¹²⁵

With this in mind, as Fotak et al. have noted, ‘as far as the market is concerned, since the stock is being temporarily borrowed anyway (whether voluntarily or otherwise), there should not be any functional consequences arising from whether a short sale ultimately results in a FTD or not’.¹²⁶ Consequently the SEC’s decision to subsequently remove this ability to fail is particularly questionable, especially when automatic processes already exist to tackle any settlement delays.

Temporary Rule 204T

Rule 204, was preceded by temporary rule 204T introduced in September 2008. It enhanced delivery requirements on broker-dealers with respect to the sale of all equity securities and aimed to close out FTDs that could allow naked short sale positions to persist.¹²⁷ The SEC justified this by reference to its concerns about sudden and excessive fluctuations in securities prices, stating that this could threaten fair and

¹²⁵ Ibid 50. Culp and Heaton also suggest that the buyer in this situation acts as the effective lender with a very solvent counterparty in the form of the NSCC and suggest that this also provides the buyer with an ability to purchase a share that would otherwise not exist if the security was unavailable for borrowing from its current owner and that this creates desirable competition in the securities lending market.

¹²⁶ Fotak, Raman and Yadav (n 119) 495.

¹²⁷ See SEC, ‘Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58572’ (n 119). An exception was included for bona fide market-making activities however.

orderly markets.¹²⁸ It was also particularly concerned about naked short selling and that some persons could take advantage of issuers that had become temporarily weakened by market conditions to engage in inappropriate short selling in the securities of such issuers.¹²⁹

The temporary rule provided that participants of registered clearing agencies must deliver securities for settlement by the settlement date (usually T+3).¹³⁰ Under rule 204T(a) if the participant had a FTD position then this must be closed out by the morning of the day after settlement (usually T+4) by borrowing or purchasing securities of like kind and quantity. However if the participant had such a FTD and failed to close out the position, the participant became subject to a ‘pre-borrow’ penalty. This meant the participant could not then either accept or effect a short sale for its own account without first pre-borrowing the security or entering into a bona fide agreement to borrow it, until the participant closed out the FTD by purchasing securities and that purchase had cleared and settled.¹³¹

Rule 204

In July 2009, to continue advancing the goal of reducing FTDs, and to address potentially abusive naked short selling, the SEC stated it was permanently adopting the substance of rule 204T as rule 204.¹³² The rule was adopted with minor modifications that included providing extra time during which particular fails could

¹²⁸ Ibid 1.

¹²⁹ Ibid 1.

¹³⁰ Ibid 2. The rule covered both long and short positions.

¹³¹ Rule 204T(b). Ibid 4-5.

¹³² SEC, ‘Amendments to Regulation SHO, Release No. 34-60388 (Final Rule)’ (27 July 2009) 12.

be closed out.¹³³ It should also be noted that although rule 204 essentially eliminated rule 203(b)(3) it did not specifically remove rule 203(b)(3).

When requesting comments on this rule, the SEC received responses voicing concern about the rule's potential market impact. For instance it was noted that because rule 204T had required participants to close out positions by the opening of trading on the applicable date, the rule inadvertently had negative consequences including increased volatility, price spikes, increased instability in the securities lending markets, and increased costs to investors.¹³⁴ Some also suggested allowing the close out to be at the end of regular trading hours on the applicable date, or extending the close out date for short sales to three settlement days after the FTD occurred.¹³⁵ However the SEC stated that the benefits of the rule in significantly reducing FTDs and eliminating any potentially abusive naked short selling justified the potential effects.¹³⁶

The SEC also put a lot of weight on the preliminary results from its Office of Economic Analysis ('OEA') that indicated that the SEC's efforts were having their intended effect in further reducing FTDs.¹³⁷ However notably although the OEA analysis pointed to a significant downward trend in the number of FTDs since Rule 204T was adopted, the analysis did not consider that the existence of short selling

¹³³ These exceptions included fails resulting from long sales or from bona fide market making activities, see Regulation SHO rule 204(a)(1) and (3).

¹³⁴ See e.g. Securities Industry and Financial Markets Association, *Amendments to Regulation SHO - Rule 204T* (16 December 2008) 2. This was due to the need to execute potentially large purchases at the market opening.

¹³⁵ SEC, 'Amendments to Regulation SHO, Release No. 34-60388 (Final Rule)' (n 132) 58-59.

¹³⁶ *Ibid* 20.

¹³⁷ *Ibid* 3.

restrictions would have reduced the amount of short selling and also most likely reduced the number of FTDs.¹³⁸

Comments

Rule 204 is a far-reaching regulatory step by the SEC that virtually precludes naked short selling.¹³⁹ As discussed in Chapter 2 and in this Chapter, there are no legal and economic justifications for a different regime for naked short selling. Although by essentially banning naked short sales the SEC can eliminate any manipulative naked short selling that does take place, it does so at the cost of market efficiency. Instead, rather than seeking to remove the ability to fail, in line with the EU's approach, settlement periods could be further tightened to T+2, and financial penalties could be introduced to deter FTDs. Regulators should also focus on removing any incentives to FTD by seeking to enhance the transparency and regulation of the stock borrowing market.¹⁴⁰

4.3.3.5 Naked Short Selling Anti-fraud Rule: Rule 10b-21

¹³⁸ Grunewald, Wagner and Weber (n 93) 131. See also Fotak, Raman and Yadav (n 119) 495 who examine the earlier naked short selling ban that imposed pre-borrowing requirements on short sales. Their findings demonstrated that although FTDs considerably reduced, market efficiency was negatively impacted.

¹³⁹ Grunewald, Wagner and Weber (n 93) 122.

¹⁴⁰ See Fotak, Raman and Yadav (n 119) 496. It should also be observed that section 417(a)(1) of Dodd Frank also required the SEC to conduct a study on the state of short selling on national securities exchanges and in the OTC markets with particular attention to the impact of recent rule changes and the incidence of FTDs sold short, or delivery of shares on the fourth day following the short sale transaction. Although this study was due by 21 July 2012, the SEC did not meet this deadline and at the time of writing had still not submitted its study.

During the financial crisis the SEC also implemented the anti-fraud rule: rule 10b-21. This was first implemented on a temporary basis in September 2008 at the same time as rule 204T, and was then adopted as a permanent rule in October 2008.¹⁴¹

The SEC stated it had become aware that a broker-dealer may be deceived by a customer who claimed to have a locate for a security when it had not identified a lender.¹⁴² As a broker-dealer was allowed to rely on representations of a customer in relation to a locate, the broker-dealer may FTD through no fault of its own.¹⁴³ Thus the SEC stated that the rule was being adopted to address FTDs and would further evidence the liability of short sellers, including broker-dealers dealing on their own account, who deceived specified persons about their intention or ability to deliver securities in time for settlement and that failed to deliver securities by the settlement date.¹⁴⁴

The rule stated that ‘it shall also constitute a manipulative or deceptive device or contrivance’ as used in Section 10(b) of the Securities Exchange Act 1934 (the ‘Exchange Act’) for any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser, about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.¹⁴⁵ The SEC stipulated that ‘scienter’ was a necessary element for a

¹⁴¹ SEC, ‘Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58572’ (n 119); SEC, ‘Naked’ Short Selling Anti-Fraud Rule, Release No. 34-58774 (Final Rule)’ (14 October 2008).

¹⁴² Sirri (n 116) 525.

¹⁴³ Ibid 525.

¹⁴⁴ SEC, ‘Naked’ Short Selling Anti-Fraud Rule, Release No. 34-58774 (Final Rule)’ (n 141) 1.

¹⁴⁵ Ibid 41.

violation of the rule: a mental state embracing the intent to deceive, manipulate or defraud.¹⁴⁶

Given that the rule neither substantively amplified nor extended the previously existing regulations on naked short selling or market manipulation, the need for the SEC to introduce this additional rule must be questioned.¹⁴⁷ Rather, it would have been more sensible for the SEC to take stronger enforcement action under existing laws rather than adopting new rules.¹⁴⁸ Once again however, it is likely that the main driver behind the rule's adoption was political pressure that compelled the SEC to respond to the public aversion to naked short selling.¹⁴⁹

4.3.3.6 Assessment

Since Regulation SHO's introduction, but particularly with the advent of the financial crisis, the SEC began increasing the pressure to borrow shares prior to short selling. This has culminated in effectively seeking to eliminate naked short selling with the introduction of rule 204.¹⁵⁰ As we have observed, FTDS do not call for the removal of naked short selling, rather, such concerns calls for tight settlement procedures and the

¹⁴⁶ Ibid 15.

¹⁴⁷ Grunewald, Wagner and Weber (n 93) 120. Indeed the SEC goes as far as to say that rule 10b-21 does not impose any additional liability or requirements beyond those of any existing Exchange Act rule.

¹⁴⁸ SEC, 'Naked' Short Selling Anti-Fraud Rule, Release No. 34-58774 (Final Rule)' 21. See further *ibid* 21-22. See also e.g. Securities Industry and Financial Markets Association, *Proposed Rule 10b-21* (22 May 2008) 2-3; EWT, *Amendments to Regulation SHO* (25 November 2008) 2.

¹⁴⁹ Grunewald, Wagner and Weber (n 93) 120.

¹⁵⁰ Douglas M. Branson, 'More Muscle Behind Regulation SHO? Short Selling and the Regulation of Stock Borrowing Programs' (2010) 5 *Virginia Law & Business Review* 1, 6.

NSSC already has efficient systems in place.¹⁵¹ Equally, better enforcement of market abuse rules is preferable to eliminating all naked short selling that removes the benefits it brings to market efficiency.

We have also observed that the SEC's stance to short selling regulation changed with the financial crisis and it is important to recognise that the SEC is an agency that is 'at once independent and beholden'.¹⁵² Although it is an independent executive agency that can work without regard to the wishes of the President, it is also a political agency that must show its responsiveness to Congress.¹⁵³ Crucially, the SEC is also not self-funded: it is required to approach Congress annually to justify its programs and seek funds for the following year.¹⁵⁴

It has already been suggested in Chapter 3 that the SEC's position became considerably weakened, particularly through failing to spot the Madoff Ponzi scheme fraud, and due to its lack supervision of the investment banks, most of who suffered turmoil during the crisis.¹⁵⁵ Further it is clear that the external influences on the SEC rose considerably during the financial crisis. Specifically various Congressmen demanded the SEC carry out investigations into short selling practices, and there was

¹⁵¹ Veljko Fotak, Vikas Raman and Pradeep Yadav, 'Naked Short Selling: The Emperor's New Clothes' American Finance Association Denver Meetings Paper (2010), 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573163> accessed 19 November 2012.

¹⁵² Sirri (n 116) 534. See also Luca Enriques, 'Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View' (2009) 30 University of Pennsylvania Journal of International Law 1147, 1150.

¹⁵³ Sirri (n 116) 534.

¹⁵⁴ Ibid 534.

¹⁵⁵ See Chapter 3 section 3.3.3. See also ibid 535; David P. McCaffrey, 'Review of the Policy Debate over Short Sale Regulation During the Market Crisis' (2009) 73 Alb L Rev 483, 514.

also considerable pressure placed on the agency from the US administration.¹⁵⁶ Indeed former SEC Chairman Cox stated that he had come under intense pressure from both the Federal Reserve and the Treasury Department to impose temporary short selling bans in 2008.¹⁵⁷ Thus in order to maintain its jurisdiction going forward, pleasing the political critics who held the SEC's purse strings may have been an essential part of its policy trade-off.¹⁵⁸

Going forward, the SEC should seek to re-assert itself as the regulatory agency in charge of short selling policy and a step in the right direction would be returning to a more measured and balanced approach to short selling regulation.¹⁵⁹ In particular it could start by reverting to its former approach of focusing only on threshold securities with prolonged FTDs rather than implementing sweeping market restrictions that risk considerable unintended consequences.¹⁶⁰

4.3.4 Permanent Restrictions in the EU and US: Concluding Remarks

Although the approach taken to permanent short selling restrictions has varied on both sides of the Atlantic, the end result has been functionally the same. In the EU, the strict interpretation of the technical arrangements implementing the locate and

¹⁵⁶ See e.g. Committee on Financial Services - Democrats, 'Barney Frank Letter to SEC Chairman Cox: Short Sales of Bear Stearns and Other Investment Bank Stock' (4 April 2008) <<http://democrats.financialservices.house.gov/press110/press0404083.shtml>> accessed 17 January 2014

¹⁵⁷ See e.g. Rachele Younglai, 'SEC Chief Has Regrets over Short-Selling Ban' *Reuters* (31 December 2008).

¹⁵⁸ Sirri (n 116) 535. Sirri also notes that large scale regulatory reforms were being proposed so the SEC may not have wanted to risk losing a large part of its authority over a matter as transitory as short selling. See also McCaffrey (n 155) 518-519 where McCaffrey notes that the SEC's political position was not such that it could resist key legislators' views on short sale restrictions.

¹⁵⁹ See e.g. EWT (n 148) 8.

¹⁶⁰ *Ibid* 8.

borrowing arrangements amount are tantamount to a de facto ban on naked short selling, and in the US the locate requirement in conjunction with the FTD rules equate to the same. In fact the US goes even further than the EU with its strict restrictions imposed on all short selling before SEOs. It is also clear that unfounded political concerns as to naked short selling's negative effects were behind both the Regulation's push to restrict naked short selling, and the SEC's approach to regulation following the crisis: the implementation of the anti-fraud rule being just one clear example of this.

4.4 EU Short Selling Regulation: Temporary Restrictions

4.4.1 Overview

Moving to consider the EU's temporary short selling restrictions, the Commission stated it had received opinions from some regulators that short selling could amplify price falls in distressed markets, lead to bank runs, and have a contagion effect.¹⁶¹ The Commission noted that regulators' concerns had been sufficient for many to temporarily ban or restrict short selling during the financial crisis despite the lack of empirical evidence linking short selling and negative price falls, and that most had expressed support for clear powers in exceptional situations to guard against this risk in the future.¹⁶²

¹⁶¹ Impact Assessment (n 12) 25-26.

¹⁶² Ibid 25-26.

This section examines the temporary measures introduced in the Regulation due to the unfounded concerns of regulators as to short selling's negative effects during the crisis. In contrast to the permanent restrictions on uncovered short sales that only apply to specific instruments (and that only encompass direct short sales), the temporary restrictions provide that in exceptional situations, national regulators have far reaching powers to impose a number of temporary measures including temporary bans on all short sales, and 'circuit breaker' powers. This section suggests that, as observed in Chapter 2, the empirical evidence does not support the imposition of such temporary measures and that they can in fact be harmful to markets. This section will also consider the difficulties in implementing these measures in practice including the ineffectiveness of introducing a measure on only one trading venue. ESMA's ability to intervene in exceptional situations, and the recent unsuccessful UK challenge to these powers will also be discussed. Specifically, ESMA's new powers considerably expand its authority, far exceeding those of its predecessor CESR, and for this reason are controversial. Further, the ECJ's affirmation of these powers may also lead to further centralisation of powers at the European level, without the threat of future legal challenges.

4.4.2 Temporary Restrictions: All Short Sales

4.4.2.1 Article 20

In contrast to the Regulation's permanent restrictions that apply only to direct short sales, article 20 enables NCAs to prohibit or impose conditions on all short selling and equivalent transactions in exceptional circumstances (i.e. it extends to cover

synthetic short sales through e.g. derivatives).¹⁶³ The relevant NCA is defined as the competent authority of the most relevant market in terms of liquidity for the financial instrument in question.¹⁶⁴ In the case of shares, the most relevant market in terms of liquidity is the Member State where the share is first admitted to trading on a regulated market.¹⁶⁵ Other NCAs can impose a temporary restriction, but only with the consent of the relevant NCA.¹⁶⁶

Article 20 provides that a NCA may prohibit or impose conditions relation to persons entering into short sales and similar transactions where there are ‘adverse events or developments’ constituting a serious threat to financial stability or market confidence in the Member State concerned or in one or more other Member States. The measure may be imposed if it is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets that is disproportionate to its benefits.¹⁶⁷

4.4.2.2 Criteria and Factors

Article 24 of Delegated Regulation 918/2012 provides a non-exhaustive list of criteria and factors to be taken into account in determining when adverse events or

¹⁶³ Regulation 236/2012, arts 20(1) and (2).

¹⁶⁴ Ibid, art 2(1)(j)(v); Commission Regulation No 1287/2006 of 10 August 2006 Implementing Directive 2004/39/EC as Regards Record-Keeping Obligations for Investment Firms, Transaction Reporting, Market Transparency, Admission of Financial Instruments to Trading, and Defined Terms for the Purposes of That Directive [2006] OJ L 241/1, art 2(7).

¹⁶⁵ Regulation No 1287/2006, art 9(2).

¹⁶⁶ Regulation 236/2012, art 22.

¹⁶⁷ The measure may be applicable in all circumstances or be subject to exceptions specified by the NCA that can include market-making activities.

developments and threats arise.¹⁶⁸ Such adverse events or developments can include any act, result, fact, or event that is or could be reasonably expected to lead to serious financial, monetary, or budgetary problems that may lead to financial instability concerning a Member State or systemically important financial institution operating within the EU when this may threaten the orderly functioning and integrity of financial markets or stability of the financial system in the EU.¹⁶⁹ Articles 24(1)(b)-(e) also provide further examples including substantial selling pressure causing significant downward spirals in financial instruments related to systemically important financial institutions.¹⁷⁰ It also extends beyond financial and economic events to include relevant damage to physical structures of important financial issuers and others that may adversely affect markets in particular where this results from a natural disaster or terrorist attack.¹⁷¹

4.4.2.3 Notices and Notifications

Under article 25 of the Regulation, a NCA is required to publish on its website notice of any decision to impose or renew any measure under article 20. The notice must specify details of the measures imposed, including the instruments and classes of transactions to which they apply, their duration, and the reasons why the NCA

¹⁶⁸ Commission Delegated Regulation (EU) 918/2012 supplementing Regulation No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps with Regard to Definitions, the Calculation of Net Short Positions, Covered Sovereign Credit Default Swaps, Notification Thresholds, Liquidity Thresholds for Suspending Restrictions, Significant Falls in the Value of Financial Instruments and Adverse Events [2012] OJ 274/1.

¹⁶⁹ Ibid art 24(1)(a).

¹⁷⁰ Ibid art 24(1)(c).

¹⁷¹ See also ESMA, 'Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263' (April 2012) 65-66.

believes it is necessary to impose the measures including the evidence supporting those reasons.¹⁷² Under article 25(3) the measure shall take effect when the notice is published or at a time specified in the notice that is after its publication. Further before imposing or renewing any measure, a NCA is required to notify ESMA and other NCAs under article 26.¹⁷³ This must be made not less than 24 hours before the measure is intended to take effect or renewed, although in exceptional circumstances it can be made in less than 24 hours.¹⁷⁴ A measure imposed under article 20 will be valid for an initial period not exceeding three months from the date of publication of the notice.¹⁷⁵

ESMA provides a facilitation and coordination role in relation to such measures.¹⁷⁶ ESMA is to ensure a consistent approach by NCAs competent in relation to the measures taken. Further, after it receives a notification, ESMA shall within 24 hours issue an opinion under article 27, published on its website, on whether it considers the measure or proposed measure is necessary to address the exceptional circumstances.¹⁷⁷ If a NCA proposes to take, takes, or declines to take measures contrary to an ESMA opinion, the NCA shall publish on its website within 24 hours of receiving ESMA's opinion a notice fully explaining the reasons for doing so. Where this arises ESMA shall consider whether the conditions are satisfied and

¹⁷² Regulation 236/2012, art 25(2).

¹⁷³ Ibid art 26(1).

¹⁷⁴ Ibid art 26(3). Further under article 26(4) a NCA that receives notification under this article may also take measures where it is satisfied the measure is necessary to assist the NCA making the notification.

¹⁷⁵ Ibid art 24.

¹⁷⁶ Ibid art 27(1).

¹⁷⁷ Ibid art 27(2).

whether it is an appropriate case for the use of its powers of intervention under article 28.¹⁷⁸

4.4.2.4 Article 20 Emergency Measures

Since the Regulation's introduction three emergency measures have been imposed, two of which extended pre-existing national bans.¹⁷⁹ In Greece a ban originally introduced in July 2012 to prevent the short sale of shares trading on the Athens Stock Exchange was partially lifted in February 2013 but continued to apply to seven bank stocks until July 2013.¹⁸⁰ In Spain an existing ban on taking net short positions of shares listed on the Spanish official secondary market was originally adopted in July 2012, extended for three months in November 2012 and fully expired in February 2013.¹⁸¹ Italy also imposed a ban on the creation of new, or an increase in existing net short positions with respect to the shares and related instruments in two banks in October 2014 (after the publication of ESMA's Evaluation) that it subsequently extended until January 2015.¹⁸² ESMA has supported the imposition of all these measures although its opinions have been relatively brief, and have broadly reiterated the wording specified in article 27 of the Regulation.¹⁸³ ESMA's Evaluation also concluded that the article 20 provisions were necessary and appropriate and the Commission subsequently concurred.¹⁸⁴

¹⁷⁸ Ibid art 27(3). ESMA's direct intervention powers will be examined at section 4.4.3 below.

¹⁷⁹ ESMA (n 47) 40.

¹⁸⁰ ESMA, *Opinion on Greek Emergency Measures* (ESMA/2013/542).

¹⁸¹ ESMA, *Opinion on Spanish Emergency Measures* (ESMA/2012/715).

¹⁸² ESMA, *Opinion on Italian Emergency Measures* (ESMA/2014/1355).

¹⁸³ See e.g. ESMA, *Opinion on Greek Emergency Measures* (n 181) 2.

¹⁸⁴ ESMA did suggest further guidelines and recommendations may be envisaged to improve communication and publication when such bans were introduced however; Commission, 'Report on

Feedback from Market Participants

Despite ESMA's view, the impact of these article 20 bans has been mixed. For instance market participants observed dramatically reduced liquidity in relation to the Spanish ban including a reduction in volume compared with other European shares,¹⁸⁵ and it was also suggested that the temporary bans distorted the fair value of securities by removing one large set of participants.¹⁸⁶ A high level of uncertainty also existed concerning the scope of the Spanish ban, particularly whether it included index linked instruments, such as derivatives referenced to global or pan-European indexes which included one or more shares subject to the emergency measure.¹⁸⁷

Based on our findings in Chapter 2, we should question the usefulness of imposing these temporary measures given there is no conclusive evidence that taking short positions on is harmful to the financial system or to market confidence.¹⁸⁸ Further as prohibitions may result in a loss of price efficiency and liquidity it could also be queried whether introducing such measures are in fact necessary under article

the Evaluation of the Regulation on Short Selling and Certain Aspects of Credit Default Swaps' (n 49) 8.

¹⁸⁵ See e.g. BME Spanish Exchanges, *Comments on ESMA Call for Evidence* (15 March 2013) 1.

¹⁸⁶ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (n 47) 44.

¹⁸⁷ See e.g. AIMA (n 67) 12; Allianz SE, *Call for Evidence* (15 March 2013). In particular there was dispute about whether or not short positions in foreign indices were banned solely because of Spanish shares in the relevant index. Part of this debate stemmed especially from the fact such shorting had been previously permitted under the previous national ban in certain circumstances (i.e. to hedge general market risk).

¹⁸⁸ Eumedion, *ESMA Call for Evidence* (15 March 2013) 7.

20(1)(b) and will not have a detrimental effect on the efficiency of financial markets disproportionate to their benefit.¹⁸⁹

Notices and Notification of Restrictions

Next, given the urgency inherent in the imposition of these measures it is imperative that the information is communicated widely to market participants in a timely fashion. This is certainly not the case when participants are required to check 28 NCA websites, and when there is no requirement that the information be notified in a common language.¹⁹⁰ Indeed many market participants considered the information published to be insufficient, and found the method for publication and communication inadequate and inefficient.

More generally there is a lack of detail in the Regulation about the conditions for implementation, timing, and scope of the bans and this makes implementation more difficult. Indeed, despite ESMA's coordination role, in practice there has been a lack of coordination between NCAs when a ban has been imposed on the securities of an issuer traded on several European venues. This has resulted in uncertainty regarding which instruments trading on what venues are within the scope of a restriction and has imposed unnecessary costs on market participants.¹⁹¹ Specifically both long and short trading of certain instruments outside the scope of the emergency measures had been affected during the period before market participants reached absolute certainty in having their concerns addressed that particular instruments may

¹⁸⁹ Regulation 236/2012, art 20(1)(b); Eumediton (n 188) 7-8.

¹⁹⁰ See e.g. Societe Generale, *Response to the ESMA Call for Evidence* (March 2013) 2.

¹⁹¹ AIMA (n 67) 12.

be within the scope of the measures.¹⁹² This has had an immediate negative effect on the price efficiency, liquidity, and investment in such instruments.¹⁹³

Impact of Lifting the Bans

Turning to the impact of lifting the bans, this also seemed to have a mixed impact on markets. Using daily data, ESMA considered transaction volume, bid-ask spreads, price returns, and returns volatility.¹⁹⁴ Based on the limited existing evidence, lifting the bans seemed to increase trading volume, have no significant effect on bid-ask spreads and price returns, and have mixed effects on volatility.¹⁹⁵

4.4.2.5 Comments on Article 20

Although the European rules aim to avoid the go-it-alone ban strategies that dominated the financial crisis through allocating one ‘relevant’ NCA in conjunction with notification requirements to other NCAs, in practice a lack of coordination remains between the NCAs. Although ESMA has a facilitation and coordination role,

¹⁹² Ibid 12.

¹⁹³ Ibid 12.

¹⁹⁴ ESMA, ‘Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps’ (n 47) 43.

¹⁹⁵ Ibid 43-44; 81. In Spain, lifting of the ban was followed by an increase in trading volumes, however there was no significant effect on bid-ask spreads. In relation to prices, lifting the ban did not have a significant effect on daily price returns or volatility. In Greece when the ban was lifted for non-financial shares but prolonged for seven banking stocks the impact was mixed: the ban lift was followed by higher relative volumes for non-financial shares however bid-ask spreads were not significantly impacted. Lifting the ban had no significant effect on daily price returns but had a significant effect on volatility, resulting in higher volatility for non-financial shares after the ban was lifted.

in the absence of it utilising article 28 and intervening itself, it has no real authority to prevent NCAs from implementing incoherent approaches.¹⁹⁶

We have observed that the lack of harmonisation has led to uncertainty and imposed unnecessary costs and delays on investors. The impracticality of having to check all the NCAs' websites and the absence of a requirement to publish information in a common language has also caused problems. Such issues are especially concerning given the perceived urgency inherent in introducing such emergency measures. The lack of standardisation in announcing a ban also means there can be delay between the ban being announced and the measures taking effect. Indeed if a temporary ban is going to have any impact, notice should only be required at the precise time the measure comes into effect otherwise there is a great risk that the effectiveness of the measure will be undermined.¹⁹⁷

As observed in Chapter 2, the empirical data does not support the imposition of such measures and suggests that such measures can in fact be harmful to markets.¹⁹⁸ This is reinforced by the bans recently imposed where the impact has been mixed. It is suggested that the article 20 temporary restrictions are detrimental to the functioning of efficient markets and should be removed. In the absence of this occurring however, given the importance of coordination in the event short selling restrictions are to be imposed, it may seem sensible (although also controversial) to in fact remove these powers from the NCAs and fully centralise them with ESMA. We

¹⁹⁶ Rodolphe Baptiste Elineau, 'Regulating Short Selling in Europe after the Crisis' (2012) 8 *International Law & Management Review* 61 (n) 83.

¹⁹⁷ See FSA, HMT and Debt Management Office, *Joint FSA/HMT/Debt Management Office Response to the European Commission Public Consultation on Short Selling* (2010) 13-14.

¹⁹⁸ See e.g. Chapter 2 section 2.2.1.2.

will also explore this issue further at section 4.4.3 below. On a more practical level, to at least reduce the communication problems that have arisen in practice, it would be helpful to introduce a single platform or website to communicate information, and to require all communications to either be in a common language or translated into all necessary languages.

4.4.2.6 Article 23 Circuit Breakers

Turning to article 23, this provides NCAs with the power to restrict temporarily short selling of financial instruments on trading venues in the case of a significant fall in price. Article 23(1) provides that where the price of a financial instrument on a trading venue has fallen significantly during a single trading day in relation to the closing price on that venue on the previous trading day, the NCA of the home Member State for that venue shall consider whether it is appropriate to prohibit or restrict persons from engaging in short selling of that instrument or otherwise limit transactions in that instrument to prevent a disorderly decline in the price of the instrument.

Under article 23(5) the intra-day fall in value that triggers consideration as to whether to exercise these powers shall be 10 per cent or more in the case of a liquid share.¹⁹⁹ Delegated Regulation 918/2012 sets out the various relevant thresholds for

¹⁹⁹ ‘Liquid share’ is as defined in Regulation No 1287/2006, art 22. Broadly speaking this provides that a share admitted to trading on a regulated market shall be considered to be a liquid market if the share is traded daily with a free float (i.e. are freely available for purchase) of not less than EUR 500 million and either the average number of daily transactions is not less than 500 or the average daily turnover for the share is not less than EUR 2 million.

illiquid shares and other types of financial instrument,²⁰⁰ and Delegated Regulation 919/2012 specifies the method of calculation for the significant fall in value for liquid and illiquid shares and for other financial instruments. With respect to liquid and illiquid shares, the fall in value is calculated from the official closing price of the previous trading day at that trading venue.²⁰¹

As with article 20, the NCA must publish on its website notice of any decision to impose or renew a measure under article 25 and must notify ESMA and other NCAs before any restriction is intended to take effect under articles 26(1) and (3).²⁰² A double notification requirement is also technically imposed on NCAs, as article 23(4) also requires a NCA to notify ESMA about its decision to impose the restriction at the latest 2 hours after the end of the trading day that the significant fall occurs. Although ESMA is less involved with article 23 than with article 20 due to the urgency in the circuit breaker measure, ESMA shall immediately inform the NCAs of the home Member States of venues that trade the same financial instrument.²⁰³ There is then a very limited window for other NCAs to disagree with the action taken and ESMA may assist them using conciliation with ESMA acting as mediator.²⁰⁴

²⁰⁰ Delegated Regulation 918/2012, art 23. These instruments include illiquid shares (which is broken down into three further categories based on their relative liquidity); debt instruments issued by sovereign and corporate issuers; exchange-traded funds; money-market instruments; and derivatives whose sole underlying is a financial instrument traded on a trading venue.

²⁰¹ Commission Delegated Regulation (EU) No 919/2012 of 5 July 2012 supplementing Regulation No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps with Regard to Regulatory Technical Standards for the Method of Calculation of the Fall in Value for Liquid Shares and Other Financial Instruments [2012] OJ 274/16, art 2. However the method of calculation excluded any downward movement of price resulting exclusively from a share split (a share split is a corporate action in which a company splits its existing shares into multiple shares), any corporate action or similar measures by the issuer.

²⁰² Under article 26(4) NCAs that receive a notification may also take measures where satisfied the measure is necessary to assist the NCA making the notification.

²⁰³ Regulation 236/2012, art 23(4).

²⁰⁴ *Ibid* art 23(4). This must be completed by midnight at the end of the same trading day. If the NCAs fail to reach an agreement within the conciliation phase ESMA may take a decision before the opening

Under article 23(2) the initial prohibition shall apply for a period not exceeding the end of the trading day following the trading day on which the fall in price occurs. However this can be extended for a further period not exceeding two further trading days if there is a further significant fall in value of at least half the amount specified in article 23(5) of the Regulation: for example for liquid shares this will be a further 5 per cent fall in price.

Imposition of Bans

Following the Regulation's introduction, a number of temporary prohibitions have been imposed by NCAs. For instance in January and April 2013 seven temporary bans were imposed by the Italian regulator CONSOB on seven Italian shares trading on the Milan stock exchange.²⁰⁵ The imposition of restrictions was followed in some instances by other NCAs, including the UK, who also considered it useful to impose a ban on platforms where the shares also traded. In July 2013 (after the publication of ESMA's Evaluation) Portugal also imposed a one-day short selling ban on the shares of four companies.²⁰⁶ The UK again followed suit and also temporarily banned short selling in the three Portuguese companies that traded on London-based platforms.

of the next trading day, see further Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), Amending Decision No 716/2009/EC and Repealing Commission Decision 2009/77/EC [2010] OJ L331/84, art 19.

²⁰⁵ These bans took place between January and April 2013. In all instances the shares were constituents of the Milano Italia Borsa ('MIB') and were very liquid shares.

²⁰⁶ The Portuguese short selling ban included the shares of three banks. Two of the banks (Banco Comercial Português SA and Banco Espírito Santo SA) had very liquid shares as per Regulation No 1287/2006. The other two companies' shares (Sonae Indústria and Banif Banco Internacional do Funchal) fell respectively within the arts 23(1) and (3) thresholds of Delegated Regulation 918/2012. Note that in July 2014, short selling in Banco Espírito Santo was again temporarily banned due to fears about its parent company. In August 2014 the bank was restructured and split into two banks ('good

Due to the various notifications required under article 23 and 26, the measures have been imposed with a non-trivial delay. For instance, with respect to the Portuguese measures, the regulator announced the temporary ban more than eight hours before it would take effect.²⁰⁷ Equally in relation to the Italian temporary restrictions the delay ranged from under an hour to over four hours. This undoubtedly limits the effectiveness of the measures. Similarly, by the time the Italian restrictions were publicly announced and market participants had received the information, prices had stabilised or rebounded and transaction volumes were starting to normalise.²⁰⁸ An additional problem has also been the overlap of automatic trading interruption mechanisms on trading venues (‘automatic circuit breakers’) with the imposition of the temporary bans.

In terms of price formation, analysis of the Italian bans found that they did not seem to have a significant impact although they did significantly slow the price formation process in one of the seven Italian cases. Transaction volumes of shares also tended to decrease during the Italian bans relative to the pre-ban period.²⁰⁹ The bans also did not seem to have a major impact on price volatility and ESMA found

bank’ and ‘bad bank’) under a bailout plan and the shares were delisted. See Chad Bray, ‘Short-Selling of Banco Espírito Santo Briefly Banned’ *The New York Times* (1 July 2014) and Sergio Goncalves, ‘Portugal to Rescue Banco Espírito Santo Using Remaining Bailout Money’ *Reuters* (3 August 2014).

²⁰⁷ See e.g. Patricia Kowsmann, ‘Portugal Bans Short-Selling of Three Bank Stocks’ *The Wall Street Journal* (3 July 2013).

²⁰⁸ ESMA, ‘Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps’ (n 47) 77.

²⁰⁹ ESMA defined the ‘pre-ban’ period as the period from the beginning of the sell-off to the imposition of the ban, see *ibid* 79. A decrease in transaction volumes of shares was also observed with the Portuguese bans. For example for Banco Comercial Português SA, the trading volumes during the day of the ban were 213,067,011 whereas in the day prior to the ban the transaction volumes were 564,831,297. See Reuters, ‘Banco Comercial Portugues SA’ <<http://www.reuters.com/finance/stocks/chart?symbol=BCP.LS>> accessed 7 February 2014.

that the restrictions could increase returns marginally. However this could have been due to short sellers unwinding their positions and thereby supporting prices.²¹⁰

It is also clear that due to the uncertainty stemming from the decisions at other venues to introduce a short selling restriction or take no action, market participants may have stopped all short sales on all trading venues. This would clearly have affected liquidity and price formation on the other venues. Alternatively if the market participants chose to proceed with short sales on other venues they retained the possibility to arbitrage with prices on the home platform and this could have affected the price formation analysis.²¹¹

After the termination of the Italian temporary restrictions, average transaction volumes fell sharply relative to pre-ban averages.²¹² However in general lifting the bans did not seem to have any impact on markets: overall during the day following the lift prices seemed to remain stable, and volatility remained broadly unchanged relative to the ban period. ESMA noted however that in all seven cases the bans were lifted at the close of business and that the capacity to analyse the impact of lifting the bans was limited given the short time of the bans and the importance of measuring intra-day price behaviours and trading volumes.²¹³

²¹⁰ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (n 47) 43.

²¹¹ Ibid 82. Indeed ESMA found that the bans did not seem to introduce a price delay on trading venues where the ban was in place potentially due to price arbitrages with alternative venues where short sales were still allowed.

²¹² See *ibid* 79-80. This was also true for the Portuguese volumes: for example Banco Espirito Santo had a trading volume of 58,765,877 pre-ban, but this dropped to 17,489,935 the day after the ban expired, see Reuters, 'Banco Espirito Santo SA' <<http://www.reuters.com/finance/stocks/chart?symbol=BES.LS>> accessed 7 February 2014.

²¹³ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (n 47) 84.

Feedback from Market Participants

With respect to the effect of all the temporary restrictions (i.e. articles 20 and 23), there have been concerns raised as to increased volatility and widened bid-ask spreads, especially when bans are communicated at the last minute.²¹⁴ Specifically concerning article 23, there has been no evidence the bans had any significant impact on share prices. Further, short selling bans are always going to be ineffective when only imposed on a national trading venue rather than all venues trading the financial instrument.²¹⁵ Uncertainty concerning which instruments on what venues are included in a particular ban has also had a negative effect on liquidity and price efficiency.²¹⁶

Considering the Italian single share bans, there have again been inconsistencies between NCAs in implementation with respect to the same share.²¹⁷ For instance with respect to the Italian company Saipem, CONSOB banned all short selling on the Italian market but allowed for a market-making exemption, whereas the subsequent UK temporary measures that banned short selling in Saipem on UK trading venues did not.²¹⁸ Further the individual bans were released to the market and on each NCA's website at different times during the trading day.²¹⁹ Equally, although both the Portuguese and UK regulators included a market making exemption in

²¹⁴ Ibid 16.

²¹⁵ See e.g. *Societe Generale* (n 190) 2.

²¹⁶ AIMA (n 67) 12. See also section 4.4.2.4 above.

²¹⁷ See e.g. *Winterflood Securities Ltd* (n 46) 8. It noted that the CONSOB ban had been implemented for 1.5 day and the FSA ban only for 1 day.

²¹⁸ See e.g. *Deutsche Bank, ESMA Call for Evidence* (n 73) 12.

²¹⁹ See *UBS, ESMA Call for Evidence* (15 March 2013) 17, who noted that such dissemination of information was not efficient and resulted in confusion in the market.

relation to the Portuguese ban, the announcements were again released to the market at different times.²²⁰

Article 23 Procedure

Some NCAs have criticised the article 23 procedure including its short time frame for decision-making, and the complexity for the conciliation procedure.²²¹ In line with article 20, there is a lack of information published on a NCA's website and the method for publication and communication of information has been considered inefficient and inadequate.²²² Further, the existence of automatic circuit breakers that carry out the task better than the article 23 measures also raises the question why the article 23 measures were necessary in the first place.²²³

Thresholds

The article 23 thresholds should also be reviewed: specifically 10 per cent may be far too little a drop in most circumstances to impose a ban on a liquid share. For instance BP's shares are highly liquid and owned by millions of investors. When its share price plummeted by around 50 per cent following the Gulf of Mexico oil spill in 2010 this

²²⁰ For example the Portuguese regulator CMVM announced its ban during Wednesday 3rd July whereas the Financial Conduct Authority ('FCA') announced its ban to the market on the morning of Thursday 4th July.

²²¹ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (n 47) 47.

²²² See also further section 4.4.2.4 above.

²²³ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' 47.

did not mean there was a case for banning short selling of its shares.²²⁴ It also seems unnecessary for authorities to restrict short selling in financial instruments trading on SME markets, as it is hard to conceive of circumstances where a significant decline in such securities would be likely to threaten financial stability.²²⁵

ESMA proposed reworking article 23 to make introducing a temporary ban less complex and resource intensive and suggested allowing the NCA to exercise its judgment as to if and when a temporary measure was necessary without having to implement a mechanism based on thresholds for significant falls in price.²²⁶ In the event the threshold requirement remained in place, ESMA suggested raising or removing it for illiquid shares as the number of trigger events illustrated the thresholds were set too low.²²⁷ Further, to ensure a consistent approach across European markets trading a particular instrument, ESMA proposed that other NCAs should follow the measure instigated by the initial authority.²²⁸ However despite acknowledging ESMA's suggestions, the Commission decided against making changes and did not deem it necessary to revise the thresholds.²²⁹

²²⁴ See further e.g. APCIMS, *Response by the Association of Private Client Investment Managers and Stockbrokers* (2010) 11. See also Jennifer Payne, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 EBOR 413, 438. Concerns also related to instruments that trade episodically where liquidity was thin. Such instruments may not trade daily and could mislead the regulator by creating the impression that the market was disorderly when it might simply reflect episodic trading, see ICAP, *ICAP Response to Esma's Call for Evidence* (15 March 2013) 2.

²²⁵ ISDX, *Call for Evidence* (15 March 2013) 2.

²²⁶ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (n 47) 51.

²²⁷ *Ibid* 51.

²²⁸ *Ibid* 51.

²²⁹ Commission, 'Report on the Evaluation of the Regulation on Short Selling and Certain Aspects of Credit Default Swaps' 7.

4.4.2.7 Comments on Article 23

It is clear that market participants have been critical of the article 23 restrictions, highlighting the lack of impact on prices and the ineffectiveness of measures only imposed by one NCA. Indeed as with article 20, many problems in practice have ironically derived from the lack of harmonisation of responses between the NCAs. Tied in with the uncertainty as to which instruments are included in a measure this has created confusion, delay and extra costs for participants. The landscape is further fragmented when one also acknowledges that the parameters for article 23 are set from the previous trading day's closing prices yet each market has different criteria for establishing its official closing price.²³⁰

The article 23 procedure is also cumbersome, confusing and resource intensive. Further introducing restrictions following a non-trivial delay reduces the potential impact of a measure. Given that trading venues typically already have automatic circuit breakers in place that could interrupt trading as required, it is not clear why article 23 was required, particularly when it has ended up leading to practical implementation problems when article 23 overlaps with existing automatic circuit breakers.

The thresholds are also inappropriate and NCAs should not be in the habit of simply stopping declines in share prices: the market should be able to price in disaster. Further, as we observed in Chapter 2, in most cases it is not short selling that gives rise to a fall but other factors such as economic fundamentals and poor results.

²³⁰ BATS Chi-X Europe, *Call for Evidence* (15 March 2013) 4.

4.4.3 ESMA's Powers

Aside from ESMA's coordination role, ESMA is also granted direct intervention powers under article 28 of the Regulation enabling it to prohibit or impose conditions on the entry to short sales or equivalent transactions in exceptional circumstances. Notably, the political decision to grant these direct 'operational' powers on ESMA in the context of short selling was taken before the adoption of the Regulation, during the negotiations for ESMA, and the other European Supervisory Authorities ('ESAs') founding regulations.²³¹

As we observed in Chapter 3, ESMA's direct powers proved a point of contention during the Regulation's febrile negotiations. Specifically, the Parliament supported the conferral of such powers including with respect to sovereign debt and CDSs while many Member States sought a veto. Ultimately the Regulation excluded ESMA's direct intervention powers with respect to the sovereign debt markets due to concerns as to the possible effect on countries' borrowing costs. Nevertheless, some Member States continued to contest the legality of ESMA's powers, and as we will observe below, the UK subsequently challenged these powers at the ECJ.

Article 28 Conditions

Under article 28 ESMA shall take such a decision if this addresses a threat to the orderly functioning and integrity of financial markets or the stability of the whole or

²³¹ Moloney (n 32) 567.

part of the EU's financial system, there are cross-border implications, and no NCA has taken measures to address the threat or one or more authorities have taken measures that do not adequately address the threat.²³²

Article 24(3) of Delegated Regulation 918/2012 elaborates on such circumstances and these are similar to the conditions required for NCA action under article 21 of the Regulation.²³³ Article 24(3)(a) provides the circumstances shall include any threat of serious financial, monetary or budgetary instability concerning a Member State or the financial system within a Member State where this may seriously threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the EU's financial system. Under articles 24(3)(b)-(d) such circumstances also include the possibility of default by any Member State or supranational issuer; any serious damage to physical structures of important financial issuers, market infrastructures, clearing and settlement systems, and supervisors, that could seriously affect cross-border markets; and serious disruption in any payment system or settlement process when related to interbank operations that may cause significant payment or settlement failures or delays within the EU cross-border payment systems.

When taking such measures ESMA shall take into account the extent the measure significantly addresses the threat to the orderly functioning and integrity of financial markets or to the stability of the financial system in the EU or significantly improves the ability of the NCA to monitor the threat. It shall also take into account

²³² Regulation 236/2012 article 28(1) and (2).

²³³ Although note that although article 24(3) of the Delegated Regulation does not include threats to banks or financial institutions deemed important to the global financial system, or substantial selling pressure or unusual volatility relating to banks and financial institutions, see Moloney (n 32) 568-9.

the extent to which the measure does not create a risk of regulatory arbitrage, and that it does not have a detrimental effect on the efficiency of financial markets including reducing liquidity in those markets or creating uncertainty for market participants that is disproportionate to the benefits of the measure.²³⁴

There are a number of procedural requirements also placed on ESMA in relation to article 28. These include prior consultation with the European Systemic Risk Board,²³⁵ and prior notification to the NCAs concerned by the measure.²³⁶ As with the article 20 and 23 measures observed above, ESMA is required to publish notice of the decision on the website including which instruments are affected, their duration, and the reasons why ESMA is of the opinion they are necessary. Again the measure shall take effect when published on ESMA's website or at a time specified in the notice after publication.²³⁷ Measures adopted by ESMA under article 28 shall also prevail over any previous measure taken by a NCA.²³⁸

ESMA also has a number of other miscellaneous powers under the Regulation, including the ability to conduct inquiries and publish a report into a particular issue or practice relating to short selling, the power to coordinate on-site inspections or investigations with cross-border effects, and the power to coordinate the development

²³⁴ Regulation 236/2012, art 28(3).

²³⁵ In response to the crisis, the 2009 Jacques de Larosière Report recommended establishing this Union level body with a mandate to oversee risk in the financial system as a whole, see further Jacques de Larosière, *The High-Level Group on Financial Supervision in the EU: Report* (2009) 44-46. ESMA itself was also a by-product of this report.

²³⁶ Regulation 236/2012 arts 28(4)-(5). Again, as with NCA notifications the prior notification is to be not less than 24 hours before the measure is to take effect other than in exceptional circumstances. Although given that article 28 is intended to apply only in exceptional circumstances, this provision is somewhat otiose.

²³⁷ *Ibid* art 28(7) and (9).

²³⁸ *Ibid* art 28(11).

of cooperation arrangements between NCAs and relevant supervisory authorities of third countries.²³⁹

4.4.3.1 UK Constitutional Challenge to Article 28

As already observed, the conferral of direct intervention powers on ESMA has been controversial. Specifically, the question of whether there is a threat to the orderly functioning of financial markets with cross-border implications involves considerable discretionary assessment on the part of ESMA, and it is clear that there is little guidance provided beyond the criteria set out in Delegated Regulation 918/2012. Indeed more generally ESMA's direct intervention powers have been described as having the 'hue of autumn 2008'²⁴⁰ about them and they should not be lightly dismissed.²⁴¹ The combination of its direct powers, its central role in coordinating NCA emergency action, its 'softer practice-shaping powers,'²⁴² plus the limiting of NCA powers, places ESMA at the heart of crucial and delicate decisions concerning short selling and it is likely ESMA will exert considerable influence going forward.²⁴³ Further this move towards centralising powers in ESMA is also evident in other post-crisis initiatives, for example the Alternative Investment Fund Managers Directive

²³⁹ Ibid art 31, arts 37-38.

²⁴⁰ Niamh Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – a Tale of Two Competences: Part (2) Rules in Action' (2011) 12 *European Business Organization Law Review* 177, 212.

²⁴¹ Ibid 212.

²⁴² Niamh Moloney, 'Reform or Revolution? The Financial Crisis, EU Financial Markets Law, and the European Securities and Markets Authority' (2011) 60 *ICLQ* 521, 532.

²⁴³ Ibid 532. See also Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – a Tale of Two Competences: Part (2) Rules in Action' (n 240) 192, 208.

(‘AIFM’), and the European Market Infrastructure Regulation (‘EMIR’) both greatly empower ESMA’s role.²⁴⁴

With this in mind it is perhaps unsurprising that the powers were challenged at the ECJ. In 2012 the UK sought article 28’s annulment, contending it was unlawful on various grounds including that ESMA had been granted a large measure of discretion at odds with EU principles relating to the delegation of powers. It also submitted that article 114 of the TFEU was the incorrect legal basis for article 28’s adoption.²⁴⁵

Advocate General’s Opinion

In September 2013 Advocate General Jääskinen delivered his opinion, and supported the UK with respect to its article 114 TFEU submission, concluding that article 28 should be annulled.²⁴⁶ He stated that the touchstone for assessing whether the conferral of such powers of an agency fell within the scope of article 114 TFEU was whether the agency’s decisions contributed or amounted to internal market harmonisation. He noted it was difficult to envisage how the exercise of powers under article 28 could contribute to harmonisation, and suggested that the function of the powers was rather to lift intervention powers from the national to the EU level when there was disagreement between the NCAs and ESMA.²⁴⁷ Thus he considered that

²⁴⁴ Moloney, ‘The European Securities and Markets Authority and Institutional Design for the EU Financial Market – a Tale of Two Competences: Part (2) Rules in Action’ (n 240) 208-210.

²⁴⁵ For a detailed discussion see e.g. Elizabeth Howell, ‘The European Court of Justice: Selling Us Short?’ (2014) 11 ECFR 454.

²⁴⁶ Case C-270/12 *United Kingdom v Council of the European Union and European Parliament* (ECJ, 12 September 2013), Opinion of AG.

²⁴⁷ *Ibid* para 50.

the activation of ESMA's powers under article 28 went beyond the limits in article 114 TFEU: it was not harmonisation but the replacement of national decision making with EU level decision making.²⁴⁸ The Advocate General concluded this could not be considered to be encompassed by the 'approximation of the provisions laid down by law, regulation, or administrative action in Member States' under article 114 TFEU.²⁴⁹

He also considered that the residual legal basis of article 352 TFEU would have been the appropriate legal basis for adopting article 28,²⁵⁰ as the measure was necessary to attain one of the objectives set out in the treaties due to the cross-border implications of inadequate Member State action with respect to short selling in exceptional circumstances.²⁵¹ Given that article 352 TFEU required unanimity unlike article 114 TFEU, which required only qualified majority voting in Council, and given that the UK opposed article 28, this was not an irrelevant issue. Recourse to article 352 TFEU would have opened up an important channel for enhanced democratic input, as there was a requirement in article 352(2) for the Commission to bring proposals based on that article to the attention of national parliaments.²⁵²

It is hard to disagree with the Advocate General with respect to article 114 TFEU. It is clear that the effect of article 28 is not harmonisation: instead it elevates to the EU level, and more precisely to ESMA, an intervention competence that would

²⁴⁸ Ibid paras 50-51.

²⁴⁹ Ibid para 54.

²⁵⁰ This was the residual basis that could be used to attain one of the objectives in the Treaty where no other provision gave the EU institutions the necessary powers to adopt the measures.

²⁵¹ *United Kingdom v Council of the European Union and European Parliament*, Opinion of AG (n 246) para 56.

²⁵² Ibid para 58.

operate in circumstances equivalent to those triggering the intervention powers of national regulators. Indeed, as the powers apply when no NCA has taken measures to address the threat or has failed to act to adequately address the threat, ESMA is therefore forming judgment on a matter that a national regulator has already reached a different conclusion.²⁵³ Further a measure adopted by ESMA will also prevail over any previous measure taken by a national regulator.

The ECJ Judgment

Although Advocate General opinions are only of persuasive weight, in practice the ECJ often follows them. Despite this however, in January 2014 the ECJ dismissed the UK's challenge, choosing to disagree with its Advocate General. Further, in contrast to the Advocate General's thoughtfully considered and detailed legal opinion, the ECJ's judgment was short and lacking any deep analysis. Rather than directly engaging with the Advocate General's argument concerning article 114 TFEU, the ECJ simply stated that article 28 of the Regulation was directed at the harmonisation of the Member States' laws, regulations and administrative provisions relating to the supervision of a number of stocks, and then affirmed the legislative view as to its choice of legal basis for article 28.²⁵⁴

4.4.3.2 Assessment

²⁵³ Ibid para 40.

²⁵⁴ Case C-270/12 *United Kingdom v Council of the European Union and European Parliament* (ECJ, 22 January 2014), paras 112, 114-115; Stephen Weatherill, 'Email from Stephen Weatherill' (22 January 2014).

Although there are some important practical benefits that derive from the judgment in relation to the development of the European Banking Union ('EBU'),²⁵⁵ the outcome of the ECJ's ruling creates concerns, and not only for its failure to engage with the Advocate General's arguments. The transfer of national powers to EU bodies is a serious issue and it remains unclear from the judgment what the boundaries are in relation to the conferral of these powers. Although the court's narrow and case-specific reasoning may well limit the case's importance as a precedent going forward,²⁵⁶ the question should be raised how much further we can stretch article 114 TFEU and proceed in terms of EU financial market integration without also considering whether a Treaty change is required.²⁵⁷ Further, although it remains to be seen what use ESMA will make of its new article 28 powers, it is likely ESMA will want to embrace its enhanced role going forward.²⁵⁸

It should also be queried whether short selling was a sensible model for taking more general decisions about the centralisation of powers in ESMA. As we have observed, decisions concerning short selling restraints have special features: if a decision is taken to impose constraints a uniform and coordinated cross-border response is crucial otherwise it will have little effect.²⁵⁹ Hence, although there may be strong argument in favour of centralising all powers in ESMA with respect to the

²⁵⁵ Although the precise details of the EBU are beyond the scope of the thesis, one of the EBU's pillars, the Single Resolution Mechanism, is based on article 114 TFEU. An ECJ ruling that followed the Advocate General's opinion on the choice of legal basis would have placed the future of the EBU in some jeopardy as the SRM's legal basis would have been eliminated.

²⁵⁶ Eilís Ferran, 'European Banking Union: Imperfect, but It Can Work' University of Cambridge Faculty of Law Research Paper No 30/2014, Working Paper Draft, 17 April 2014, 20 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2426247> accessed 23 April 2014.

²⁵⁷ See e.g. Alexandria Carr, *The European Court's Dismissal of the UK's Challenge to the Short Selling Regulation* (February 2014).

²⁵⁸ Although as Moloney observes, given the political and legal sensitivities surrounding these powers, ESMA is also likely to be relatively cautious before utilising these powers, see Moloney (n 32) 569.

²⁵⁹ Matteo Gargantini (n 1).

imposition of any temporary short selling restrictions, in other contexts the justification for centralisation of powers may be much weaker.²⁶⁰ Finally, on a more general note, it should also be observed that the approval by the court of these far-reaching powers in the name of harmonisation is part of a more general and worrying trend that has been evident in its case law over the past decade.²⁶¹

4.4.4 EU Temporary Measures: Concluding Remarks

The EU temporary measures were introduced due to the unfounded concerns of regulators about short selling's negative effects during the financial crisis. Despite the lack of empirical evidence linking short selling and negative price falls, we have ended up with broad powers for NCAs under articles 20, 23 plus a host of new, far-reaching powers for ESMA.²⁶² As we observed in Chapter 3, swiftly adopted rules introduced for the wrong reasons will most likely be poorly designed and may prove problematic in practice. Indeed articles 20 and 23 have already caused implementation issues with concerns ranging from reduced liquidity to the general ineffectiveness of measures being only introduced on one national trading venue.

Equally the centralising of powers in ESMA and the conferral of its direct intervention powers are major new developments, considerably extending its authority. Although the powers are only to be used in emergencies, and are subject to

²⁶⁰ Ibid.

²⁶¹ For a detailed analysis of the ECJ's lenient standard of review, see Weatherill, 'The Limits of Legislative Harmonization Ten Years after Tobacco Advertising: How the Court's Case Law Has Become a "Drafting Guide"'(n 62).

²⁶² Further, and in contrast to the EU's permanent short selling restrictions, there is also no explicit alignment between the EU's temporary short selling constraints and IOSCO's high level principles on short selling.

a number of restrictions, they also far exceed the confines of its predecessor CESR and for this reason are controversial. At the time of writing ESMA has yet to make use of article 28, but it may be only a matter of time before it seeks to directly intervene where it considers a NCA has either not taken a measure to address a threat or has taken measures that ESMA considers do not adequately address the threat. Although the signs so far suggest ESMA is likely to be cautious in its utilisation of article 28, how Member States react to such an intervention remains an open question.

4.5 US Short Selling Regulation: Temporary Measures

4.5.1 Alternative Uptick Rule

4.5.1.1 Overview

Turning to the US, this section demonstrates that it has gone further than the EU in relation to temporary restrictions with the reintroduction of a price test. It also suggests that in contrast to the careful and deliberate process surrounding the repeal of the original price test in the US, the reintroduction of a price test again derived from the political pressure placed on the SEC following the financial crisis. Indeed in line with the background to the European short selling restrictions, the reintroduction of a price test suggests the SEC's regulatory approach is currently governed more by public relations concerns than by economic findings. Similarly empirical findings examining the rule's effectiveness since its introduction have failed to document any clear benefits deriving from it and do not justify its extortionate costs.

Historically the SEC restricted short selling using what was commonly referred to as the ‘uptick rule’ under former rule 10a-1 of the Exchange Act. This was implemented in 1938 and essentially required that before a security could be sold short the price had to rise, indicating that there were active buyers in the market.²⁶³ A seller could short sell at a price above the price at which the immediately preceding sale was effected (‘plus tick’) or at a price equal to the last sale price if this was higher than the last different price (‘zero plus tick’).

The main provisions of the uptick rule remained virtually unchanged until its repeal in 2007. This was despite many changes in the securities market including the conversion to decimal pricing increments, increased trading volumes, and the advent of electronic trading all of which meant the uptick rule was less of an impediment to short selling.²⁶⁴ In addition, empirical studies conducted before 2007 demonstrated that the rule hindered the efficiency aspects of short selling, did not halt price declines and could have an adverse effect on the execution quality of short sale orders even when stocks traded in advancing markets.²⁶⁵ In 2004 the SEC conducted a multi-year pilot test suspending the uptick rule in 1000 different securities. The study found the price restrictions to be economically relevant constraints and supported their removal.²⁶⁶ After a careful and considered process that involved the pilot, many other

²⁶³ See Helena Stigmark, ‘Should Short Selling Be Regulated as a Consequence of Wall Street’s Failures? Exploring the New Alternative Uptick Rule’ (2010) 30 *The Michigan Business Law Journal* 32, 33.

²⁶⁴ See SEC, ‘Regulation SHO and Rule 10a-1, Release No. 34,55970 (Final Rule)’ (28 June 2007) 4-5.

²⁶⁵ See e.g. Jonathan Macey, Mark Mitchell and Jeffry Netter, ‘Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash’ (1988) 74 *Cornell L Rev* 799; Lynn Bai, ‘The Uptick Rule of Short Sale Regulation: Can It Alleviate Downward Price Pressure from Negative Earnings Shocks’ (2008) 5 *Rutgers Bus LJ* 1; Gordon J. Alexander and Mark A. Peterson, ‘Short Selling on the New York Stock Exchange and the Effects of the Uptick Rule’ (1999) 8 *Journal of Financial Intermediation* 90.

²⁶⁶ See e.g. Office of Economic Analysis, ‘Economic Analysis of the Short Sale Price Restrictions under the Regulation SHO Pilot’ (6 February 2007).

studies, plus opportunities for public comment, the SEC voted to remove the uptick rule in June 2007.²⁶⁷

At the time the news caused little public notice however once the financial crisis took hold the SEC came under increasing criticism for its decision. Indeed the pressure mounted to the point that the rule's repeal was described as a breach of public trust and grounds for the SEC Chairman's dismissal.²⁶⁸ Further although the SEC stated that it was not aware of any empirical evidence that the elimination of the price test contributed to increased volatility in the US markets, the SEC started to meet with considerable requests and demands for the reinstatement of a price test.²⁶⁹ As we have already observed in Chapter 3, the SEC was significantly weakened as a regulator during the crisis and less able to withstand pressure placed on it by Congress and the US administration with respect to the direction of its short selling policy.²⁷⁰ With this in mind it is perhaps unsurprising that in February 2010 the SEC introduced the alternative uptick rule: a variation on the original uptick rule.

4.5.1.2 Rule 201 Regulation SHO

²⁶⁷ Stigmark (n 263) 34; SEC, 'Regulation SHO and Rule 10a-1, Release No. 34,55970 (Final Rule)' (n 264) 9. See also Karl B. Diether, Kuan-Hui Lee and Ingrid M. Werner, 'It's SHO Time! Short-Sale Price Tests and Market Quality' (2009) 64 J Fin 37. Diether et al's empirical findings that concluded the test should be removed were corroborated by the SEC's Office of Economic Analysis.

²⁶⁸ Sirri (n 116) 536.

²⁶⁹ SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (February 26, 2010) 39. For example in January 2009 Representative Gary Ackerman, a member of the House Financial Services Committee introduced legislation to reinstate the uptick rule, see e.g. Alistair Barr, 'As Some 'Shorts' Thrive, More Calls for Regulation' *The Wall Street Journal* (10 January 2009).

²⁷⁰ See e.g. Sirri (n 116) 535-536; section 4.3.3.8 above.

The SEC voted 3-2 to adopt the alternative uptick rule describing it as a circuit breaker combined with the alternative uptick rule. Rule 201 provided that trading centres²⁷¹ were to establish, maintain and enforce written policies and procedures reasonably designed to prevent the execution or display of a short sale order of a security at a price less than or equal to the current national best bid if the price of the security decreased by 10 per cent or more from the closing price as determined by the listing market for the security as of the end of regular trading hours on the prior day.²⁷² The requirements would be imposed for both the remainder of the day and the following day and if the price continued to fall such that the circuit breaker was re-triggered the restriction period would restart.

The rule applied to ‘covered securities’ and extended to all national market system (‘NMS’) stocks (i.e. any NMS security other than options) listed on a national securities exchange.²⁷³ The restrictions applied only at such times as the national best bid for the security was calculated and disseminated on a current and continuing basis by a plan processor pursuant to a national market system plan.²⁷⁴ In practice however

²⁷¹ A trading centre is defined broadly and includes national securities exchanges or national securities associations that operate a trading facility; alternative trading facilities; exchange or OTC market makers; and broker-dealers executing orders internally, see SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (n 269) 45.

²⁷² Regulation SHO, rule 201(b)(i)-(ii). A listing market that determines that a security had declined by 10% or more is required to notify the appropriate plan processor who would disseminate this information. The definition of ‘listed market’ is contained in the effective transaction reporting plan for each security. There are two such plans: the Consolidated Tape Association (‘CTA’) Plan which disseminates transaction information for securities primarily listed on exchanges other than NASDAQ and the NASDAQ Unlisted Trading Privileges (‘UTP’) Plan (also called the ‘OTC UTP Plan’), which disseminates transaction information for securities primarily listed on NASDAQ, see *ibid* rule 201(a)(3).

²⁷³ See SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (n 269) 45-46. The rule also did not extend to cover derivative securities.

²⁷⁴ *Ibid* 89-90. Two different national market system plans, the Consolidated Quote (‘CQ’) plan, and the NASDAQ UTP plan disseminated market information for quotes (i.e. bid, ask, and size quotes) in securities. The CQ plan disseminated consolidated quotation information for securities listed primarily on exchanges other than on NASDAQ, and the NASDAQ UTP plan (that also disseminates

as the times that the national market plans disseminated trading information were different this meant price restrictions could apply at different hours enabling some short sales to fall through the net.²⁷⁵

Broker dealers would also be required to mark all orders for a sale in a security as ‘long’, ‘short’ or ‘short exempt’.²⁷⁶ Notably there were only very limited exemptions granted to the rule, and the SEC also decided not to provide an exemption for bona fide market making activity as it considered this would not advance the goals of adopting a short sale price test restriction.²⁷⁷

The SEC stated it was establishing a narrowly tailored rule that would only target securities experiencing significant intra-day price declines.²⁷⁸ Its aims were to prevent short selling, including potentially manipulative short selling, from further driving down the price of a security that had experienced a 10 per cent decline and to allow long sellers to stand at the front of the line and sell first in a declining market.²⁷⁹ It believed the rule would also help restore ‘investor confidence’.²⁸⁰ Indeed the SEC focused particularly on this concept: SEC Chairman Mary Schapiro stated that it was

transactions information) disseminated consolidated quotation information for securities listed primarily on NASDAQ, see *ibid* 88.

²⁷⁵ For example in general the CQ plan operated from 9 am - 6.30 pm whereas the NASDAQ UTP plan operated from 4 am - 8 pm. Further, participants could also pay to extend or modify a plan’s operating hours. See *ibid* (n 269) 89-90.

²⁷⁶ Regulation SHO rule 201(c)-(d). An order could be marked short exempt after the circuit breaker was triggered either if it was at a price above the national best bid or if it fell under one of the rule’s exemptions. We will also examine such marking requirements further in Chapter 5.

²⁷⁷ SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (n 269) 146. The limited exemptions included a seller’s delay in delivery and certain domestic and international arbitrage transactions.

²⁷⁸ *Ibid* 2.

²⁷⁹ *Ibid* 1-2.

²⁸⁰ *Ibid* 9.

a rule designed to preserve investor confidence and promote market efficiency.²⁸¹ She also declared that the rule struck the right balance as it recognised short selling could potentially have both a beneficial and harmful effect on markets depending on the circumstances.²⁸²

Comments

The SEC's arguments for adopting the alternative uptick rule were unconvincing and lacked firm empirical footing. There is no empirical evidence that the repeal of the uptick rule contributed to steep declines in stocks and increased volatility, and there is no evidence questioning the efficacy of the pilot studies that supported the repeal of the uptick rule.²⁸³ It is also unclear how efforts to limit legitimate short selling will somehow promote investor confidence given, as we have observed, the SEC has already taken steps to limit and punish abusive short selling.²⁸⁴

The vague concept of investor confidence also affords the SEC too much discretion to regulate: more is needed to justify regulating the securities markets, especially in the light of empirical evidence that advised against imposing such a price test.²⁸⁵ Equally the SEC's adopting release also repeatedly relies on the circuit

²⁸¹ Mary Schapiro, 'Speech by SEC Chairman: Statement at SEC Open Meeting — Short Sale Restrictions' (24 February 2010) 1.

²⁸² *Ibid* 1, 3.

²⁸³ See dissent of Kathleen Casey, 'Speech by SEC Commissioner: Statement at Open Meeting Short-Sale Restrictions' (24 February 2010) 1-2; SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (n 269) 34, 39.

²⁸⁴ Casey (n 283) 2.

²⁸⁵ See dissent of Troy Paredes, 'Speech by SEC Commissioner: Statement at Open Meeting and Dissent Regarding the Adoption of Amendments to Regulation SHO' (24 February 2010) 6.

breaker feature to discount the risk that the alternative uptick rule would adversely affect market quality. This does not mean a price test is then justified.²⁸⁶

Further, restricting short selling to allow long sellers to sell first may mean investors are less likely to buy shares when constraints increase the cost of hedging.²⁸⁷ Indeed as we observed in Chapter 2, limits on short selling can also lead to inflated prices as the views of short sellers will not be fully integrated into the market, and this could lead to investors being less willing to go long or at least insist on paying less when buying.²⁸⁸

In line with our arguments in Chapter 3, the strongest case for the rule's adoption is that it 'may mollify those who have been clamouring for reinstatement of the uptick rule and show that we have responded to their concerns'.²⁸⁹ As we have emphasised, this is not the standard by which rules should be crafted. Where it is not possible to identify with specificity the truly anticipated benefits from a proposed rule the SEC should resist the urge to act merely to say it had acted.²⁹⁰ With respect to the EU however, we should at least be grateful that it has not followed the SEC with respect to this particular branch of its regulatory policy.

Empirical Findings on Rule 201

²⁸⁶ Ibid 8.

²⁸⁷ Ibid 7.

²⁸⁸ Ibid 7.

²⁸⁹ Casey (n 283) 2-3.

²⁹⁰ Ibid 2-3.

Further weight is added to these criticisms when considering a study undertaken by Jain et al. that analysed rule 201's effectiveness. The authors focused on extreme individual stock price movements and compared daily and intraday short selling volumes for securities before and after the introduction of rule 201.²⁹¹ The authors found that even before the approval of rule 201 daily short selling declined on days with extreme negative returns and increased on days with extreme positive returns, removing the need for the rule.²⁹² This behaviour did not change after the introduction of rule 201 although the decline in short selling became more pronounced raising concerns about securities being overvalued.²⁹³

The study also examined short selling on extreme market movement days and did not find any evidence of higher short selling in stocks experiencing extreme declines even before the introduction of rule 201. Indeed short selling was more active before rather than after the price decline. The analysis also found that stocks recovered better in the absence of rule 201, the recovery process worsened following its implementation and the rule did not improve liquidity.²⁹⁴

²⁹¹ Chinmay Jain, Pankaj K. Jain and Thomas H. McNish, 'Short Selling: The Impact of SEC Rule 201 of 2010' (2011) University of Memphis Working Paper, 9 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1718137> accessed 27 February 2014; Chinmay Jain, Pankaj K. Jain and Thomas H. McNish, 'Everything Old Is New Again' (2011) 34 Regulation 30, 32. For each stock day they computed relative short selling volume of a stock as a proportion of its total trading volume. The authors also restricted their sample to stock days for which the previous day's closing price was more than \$5.

²⁹² Jain, Jain and McNish, 'Short Selling: The Impact of SEC Rule 201 of 2010' (n 291) 27. This finding held when they analysed short selling on both a daily and intraday basis.

²⁹³ Ibid 27.

²⁹⁴ Ibid 28. The authors also examined whether rule 201 would have been effective on the 'flash crash' day of 6 May 2010 (when the prices of many US based equity products experienced an extraordinary rapid decline and recovery). Through analysing short selling volume they found that rule 201 would have been ineffective in preventing such a crash and that short selling volume was not higher on days of significant market-wide decline. See *ibid* 4.

The authors also simulated hypothetical short sale orders that complied with rule 201 during autumn 2008 to examine the potential effectiveness of it in restricting short selling during the crisis. They found it would have been ineffective as the rule compliant simulated short sell orders executed at a very high rate.²⁹⁵ Indeed, in line with a similar study conducted by the SEC's OEA during September 2008, they found the rule to be more binding during periods of low volatility when it was not needed and did not detect any remarkable evidence of the rule's ability to lower execution rates of short sales in volatile periods.²⁹⁶

In sum despite the authors were unable to document any clear benefits deriving from rule 201 in ensuring fair valuations, price stability, promotion of higher liquidity, or in preventing either a sudden or more prolonged market crash.²⁹⁷

4.5.1.3 Assessment

When the SEC proposed repealing the uptick rule it received only 27 comment letters. In contrast in response to its proposals to re-introduce a price test it received over 4,300 comment letters, the overwhelming majority of whom favoured new restrictions on short sales.²⁹⁸ Indeed the numerous comments from individuals, issuers, and

²⁹⁵ The authors found that the execution rate of those orders within the next five-minute period was as high as 82.7%, see *ibid* 22-23.

²⁹⁶ The SEC's OEA investigated how restrictive a price test would have been during September 2008 and found that it would be most restrictive during periods of low volatility, counter to the intent of the rule, see Office of Economic Analysis, 'Analysis of a Short Sale Price Test Using Intraday Quote and Trade Data' (2008). The SEC also specifically referred to this study in its adopting release for rule 201, see SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (n 269) 24.

²⁹⁷ Jain, Jain and McInish, 'Short Selling: The Impact of SEC Rule 201 of 2010' (n 291) 1.

²⁹⁸ SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (n 269) 19, 44; McCaffrey (n 155) 516.

legislators favoured even tighter restrictions than those finally adopted by the SEC.²⁹⁹ In contrast to its careful process surrounding the repeal of the uptick rule that was backed up with firm empirical findings, the SEC instead relied on the nebulous concept of ‘investor confidence’ to support the re-introduction of a price test. The empirical findings since rule 201’s implementation only add fuel to the fire in demonstrating that it has not been possible to document any clear benefits deriving from the rule in spite of its considerable implementation and compliance costs.³⁰⁰

Although the new rule is in some ways less stringent than the original uptick rule in that it only restricts short sales once the circuit breaker is triggered, in other ways it can be more onerous. The original uptick rule pegged short sales to the price of the previous trade so that a security could be sold short at a price above the preceding sale, or at the last sale price if this was higher than the last different price. In contrast the alternative uptick rule only permits a short order in a security to be displayed or executed if it is above the national best bid, so it only allows short sales at a price higher than anyone is willing to pay.³⁰¹ Linked to this, as we have observed, the rule’s prioritising of long sellers during market declines should also be questioned. First, by the price test restricting short selling unless it is above the

²⁹⁹ McCaffrey (n 155) 516. For example NYSE Euronext reported that over 95% of its issuers who participated in a survey believed the market would function better with a short sale price test restriction, see SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (n 269) 28.

³⁰⁰ IOSCO also reinforces these cost concerns in its report. Although it stated that regulators could introduce price restrictions to reinforce their short selling regulatory regime, it acknowledged that introducing such tests could be operationally difficult and could involve prohibitive costs for both regulators and market participants, see IOSCO (n 37) 9-10.

³⁰¹ See Richard Ramirez, ‘Falling Short: Has the Sec’s Quest to Control Market Manipulation and Abusive Short-Selling Come to an End, or Has It Really Just Begun?’ (2011) 2 University of Puerto Rico Business Law Journal 76, 96. Note that the SEC does not specify a particular minimum increment above the national best bid in the rule 201 adopting release, however any execution or display of a short sale order must be in compliance with the rules regarding minimum pricing increments (i.e. for any NMS stock priced equal to or greater than \$1.00 the minimum pricing increment is \$0.01). See SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (n 269) 54-55.

national best bid, long sellers will exclusively dictate the market price of purchases and this could harm price discovery.³⁰² Next, the SEC appears to view short selling as less legitimate than long selling. However, as observed in Chapter 2, this is contrary to what we know to be true: short sellers provide a crucial and valuable role in our markets and in their absence there is the risk of artificially inflating prices.³⁰³ Indeed as observed in Chapter 2, it was in fact long sellers that created the price pressure on financial stocks during the financial crisis rather than short sellers.³⁰⁴

Turning to the circuit breaker threshold, as with the EU's circuit breaker provision, the 10 per cent threshold for triggering the circuit breaker seems disproportionate: although it has the benefit of legal certainty, it is doubtful that 10 per cent reflects a situation of severe deterioration as it may simply reflect a revaluing of a company by its investors.³⁰⁵ At the very least the circuit breaker threshold could have been linked to a security's opening price rather than the prior day's closing price so that after-hours news and events could have been incorporated without the corresponding price drop counting towards the 10 per cent decline that could then trigger the short sale constraint.³⁰⁶ Further, the SEC's decision not to include a market-making exemption is questionable: short sales that are used to facilitate

³⁰² SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (n 269) 224.

³⁰³ See also e.g. Paredes (n 285) 7.

³⁰⁴ Office of Economic Analysis, 'Analysis of Short Selling Activity During the First Weeks of September 2008' (2008); see also Chapter 2 section 2.2.2.

³⁰⁵ Grunewald, Wagner and Weber (n 93) 124. Grunewald et al. also note that the SEC has failed to consider how the market will factor in the existence of a circuit breaker: both its trigger and also its end will be anticipated and priced in by market participants.

³⁰⁶ See e.g. Paredes (n 285) 9.

market-making are particularly important for liquidity purposes and are not intended to drive down the price of a security.³⁰⁷

Finally it is deeply concerning to observe the paucity of empirical findings supporting rule 201's introduction. The SEC needs to be able to guarantee to the public that its rule making is both well reasoned and backed up by sound analysis: by falling short in this instance the SEC signals that it is guided less by empirical findings and more by public relations.³⁰⁸

4.5.2 EU and US Temporary Measures: Concluding Remarks

As we have observed, the EU has not followed the US's approach with respect to tick tests, and the absence of a price test in the Regulation should be welcomed.³⁰⁹ There are also additional differences in the approach to temporary restrictions that can be observed on both sides of the Atlantic. First, in the EU the temporary measures are not automatic, the NCA or ESMA has to decide whether to impose a particular restriction in a specific instance.³¹⁰ In contrast in the US if the price of a security falls by 10% or more on an intraday basis following the previous day's closing price, the circuit breaker mechanism is automatically triggered and a uniform rule then applies to all covered securities wherever traded.³¹¹

³⁰⁷ Ibid 9.

³⁰⁸ Casey (n 283) 3.

³⁰⁹ See e.g. Impact Assessment (n 12) 41 where the Commission acknowledges the many disadvantages associated with introducing a price test.

³¹⁰ This is true even with the power to impose a circuit breaker under article 23 where the wording states that a NCA 'shall consider' whether it is appropriate' to prohibit short selling following a significant price fall.

³¹¹ SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (n 269) 66.

Next the Regulation's temporary restrictions have a broader ambit than the US rules. For instance the Regulation's temporary measures apply to financial instruments generally,³¹² and cover transactions other than short sales that produce the same effect. In contrast, the US's alternative uptick rule does not have such a broad ambit, applying only to listed NMS stocks.³¹³ This divergence in approaches can cause confusion in the markets and introduce extra costs for commercial parties. Further, (and especially where regulation does not extend to synthetic equivalents) it can also enable traders to circumvent the rules.

Turning to implementation challenges, the absence of harmonised responses between different NCAs in the EU is unhelpful. ESMA's increased supervisory role and its powers of intervention are also controversial new developments although, in the context of imposing short selling restrictions, the case for a centralised and uniform response by one regulator is more persuasive than in other contexts. In contrast the US avoids such thorny issues through having the SEC as its sole short selling regulator. However having one regulator is less of a benefit when the SEC has managed to lose its way following the crisis, and its decision to reintroduce a price test is undoubtedly a backward step.

4.6 Conclusion

³¹² Regulation 236/2012, art 2(1)(a) provides this covers financial instruments regulated under the Markets in Financial Instruments Directive

³¹³ As we have observed, the broad reach of the European temporary restrictions is also in contrast to the Regulation's permanent restrictions that only apply to pure short sales.

This Chapter has examined the permanent and temporary short selling restrictions that have been introduced in both the EU and the US. In relation to the permanent restrictions, although the approach taken in the EU and US has varied to an extent, the overall end result has been functionally the same: a de facto ban on naked short selling. However the US has also gone further than the EU with its permanent restrictions on all short selling before SEOs. In contrast, although the introduction of tighter settlement rules in the Regulation can be broadly welcomed, the issue of settlement discipline is now being addressed through wider European rules on securities settlement that are in the process of repealing the short selling provisions.

Turning to the temporary restrictions, despite the inclusion of a circuit breaker mechanism in both jurisdictions, a difference in approach can be observed on both sides of the Atlantic. Specifically, although the EU has introduced new temporary restrictions (that extend to synthetic equivalents) with additional intervention powers for ESMA, it has not followed the US in implementing a short sale price test.

Ultimately, as we observed in Chapter 3, the flurry of regulatory activity seeking to restrict short selling since the crisis has been due to strong political forces. In line with Chapter 2's findings, this Chapter has demonstrated that the resulting permanent and temporary short selling constraints are detrimental to the functioning of efficient markets and should be removed. However in the absence of this occurring, short sellers may be able to utilise ambiguities in the rules in order to obtain an interpretation most favourable to them, including for instance in relation to the Regulation's locate arrangements. Similarly, in the event that the temporary restrictions are to remain in place, it may prove best to centralise these powers with

ESMA, given the need for a coordinated response, and taking account of the issues that have arisen in practice. Finally, and more generally, the existence of regulatory differences between the EU and the US, and the current lack of harmonised implementation within the EU itself, leads to confusion within markets and additional operational costs and difficulties for market participants. Such divergences also mean the rules will be ineffective in practice and will facilitate parties working round them through engaging in regulatory arbitrage.

Thus as we move into Chapter 5, we will turn to now examine the reporting obligations in place in the EU and the US. We will consider whether or not any such obligations can be beneficial to the functioning of efficient markets, and whether such requirements can help monitor any potentially abusive short selling: one of the SEC's particular concerns.

Chapter 5: How Helpful are Short Selling Reporting Rules?

5.1 Introduction

Chapter 5 examines the short selling reporting requirements applicable to shares in the EU. A two-tier system has been adopted with notification to the regulator commencing at one threshold, and disclosure to the market triggered at a higher threshold.¹ The US reporting requirements will also again be considered to provide a counterpoint against which to measure the EU provisions. To an extent this involves a somewhat technical discussion: in contrast to the European rules that are relatively clear, the US rules are rather fragmented and many of the rules stem from a variety of sources. Further, short selling reporting rules currently form only a small part of the US's regulatory framework.

This Chapter suggests that some types of confidential short selling reporting obligations can, in principle, be helpful to regulators. Increasing the level of detailed information available on significant short positions should enhance regulators' understanding of the effects of short selling and assist them in assessing and monitoring for cases of abusive behaviour or severe market disruption. However there is a caveat to this: as abusive short sellers are unlikely to provide notifications to the regulator, this may prove to be an ineffective and costly tool in practice.² Disclosure

¹ For ease of reference, a table containing some pertinent terms in this Chapter is attached as Appendix 4 to the thesis.

² Thanks to Professors Armour and Enriques for these comments. As will be discussed further below, each Member State must establish rules on penalties and administrative measures for infringements of the Regulation so the actual penalties will also vary from country to country. See also ESMA, *List of Administrative Measures and Sanctions Applicable in Member States to Infringements of the Short Selling Regulation* (September 2014).

of individual positions to the market is also particularly problematic: although it can provide useful information to the market, it constitutes a de facto restriction on short selling above the public disclosure threshold, thereby undermining short selling's contribution to market efficiency.

5.2 EU Short Selling Regulation

It should first be noted that the European short selling reporting regime was significantly less controversial than many other topics under discussion during the negotiations.³ This was firstly due to the fact that many national regulators already had direct experience with such requirements through the imposition of reporting obligations during the financial crisis.⁴ In addition, following the crisis, CESR also carried out a lengthy consultation with respect to a short selling reporting regime for shares that also provided the opportunity for detailed consideration of experience with such rules.⁵ Finally, perhaps such provisions were not that contentious as they were not at the heart of the new rules under debate. Indeed in line with what we observed in Chapter 3, following the crisis a change took place in regulatory style from reliance on 'light touch' disclosure rules to the use of more interventionist regulatory tools such as short selling bans that aligned with a more 'stability-orientated' approach to regulation.⁶

³ Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 561.

⁴ *Ibid* 561.

⁵ CESR, 'CESR Proposal for a Pan-European Short Selling Disclosure Regime' (July 2009); Moloney (n 3) 561. Note that although the CESR consultation and proposals did not extend to sovereign debt notifications, the Regulation's final provisions do extend to such reports.

⁶ See further Chapter 3, section 3.4.2.

Turning directly to the EU provisions, this Chapter suggests that in the event that reporting rules are in place, the inclusion of indirect, as well as direct, short positions in the reporting requirements should be welcomed as this provides a more complete view of the situation and again avoids short sellers easily circumventing the rules.⁷ Next, the public disclosure requirements in particular have a number of drawbacks that considerably detract from any benefits obtained. Finally, the biggest issue in practice with the new provisions has again been a lack of harmonised implementation of the rules between national regulators as this has created a major operational burden on market participants. In this regard the EU should pay careful attention to the US's development of a consolidated audit trail (this project will also be discussed in section 5.3.1.3 below). Specifically, creating a centralised reporting platform would enhance the standard of data being received and would be far more in keeping with the Regulation's recitals that state the reporting obligations are to be applied in an uniform manner throughout the EU.⁸

5.2.1 The Regulation's Reporting Rules

The Commission considered there was insufficient transparency concerning short positions in relation to both the regulator and the market and that the lack of transparency could lead to regulators being unable to monitor the implications on market orderliness or the use of short selling in connection with abusive strategies.⁹

Further, it considered that a lack of transparency could lead to information

⁷ For the definitions of 'direct' and 'indirect' positions, see Appendix 4.

⁸ Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, recital 3.

⁹ Commission, 'Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps' (15 September 2010) 3 (i.e. market destabilisation and market abuse concerns predominated).

asymmetries if other market participants were not adequately informed about the extent to which short selling was affecting prices.¹⁰

5.2.1.1 Marking and Aggregation Requirements?

Aside from the Regulation's individualised reporting requirements, the proposal for the Regulation (the 'Proposal') also originally contained provisions requiring short sales to be marked as such to distinguish them from long sales (a 'marking' or 'flagging' requirement).¹¹ Under article 6 of the Proposal, a trading venue that had shares admitted to trading would be required to establish procedures so that a person executing orders on the trading venue would be required to mark sell orders as short if the seller was entering a short sale of the share. The trading venue would then be required to publish daily information about the aggregate volume of short sales in each security.¹²

Although such rules will also be considered when we examine the US disclosure rules in section 5.3 below, it is relevant to observe here that marking

¹⁰ Ibid 3.

¹¹ Ibid art 6. Note that when market participants were questioned about the marking option in the Commission's Consultation, only approximately 11% of the 105 English responses publicly available were in favour of this (it should be noted however that many chose not to answer this question). Breaking this down further, only approximately 11% of registered organisations, 17% of public authorities, and 10% of individual contributions were broadly in favour of this option. All figures concerning the Consultation are calculated using information available on the Commission's short selling consultation website.

¹² Only approximately 31% of the 105 English responses to the Consultation were in favour of the aggregation option (again, it should be noted that many chose not to discuss this option). Breaking this down, approximately 36% of registered organisations, 22% of public authorities, and 29% of individual contributions were in favour of this option. Interestingly however, the Commission noted in its Impact Assessment that most market participants who responded favoured this option, see further European Commission, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps SEC(2010) 1055, 61.

requirements can be useful in providing regulators with information about the volume of short transactions relative to long transactions.¹³ Aggregation requirements also have the benefit for short sellers of not revealing information to the market about the positions of any individual market participant.¹⁴ Further, as other jurisdictions already have such types of requirements in place, introducing uniform requirements across EU trading venues could help enhance global harmonisation: an important consideration in highly integrated international markets.¹⁵

However, such requirements also have drawbacks. For example introducing a marking requirement in isolation, and only on trading venues, will not help capture short positions obtained through the use of OTC derivatives. This means that regulators will not have a complete picture of which market participants hold a short position and such requirements could also be circumvented.¹⁶ Further, marking requirements do not provide regulators with information about outstanding short positions in the market or necessarily enable them to identify any large short positions.¹⁷ Next, the mechanics of aggregation mean there will be inherent imperfections in the data: for example where large entities hold shares through short and long positions in different parts of their organisation, it may not necessarily be clear overall whether a sale is a short sale or a reduction in a long position.¹⁸

¹³ Ibid 56.

¹⁴ CESR, 'Report: Model for a Pan-European Short Selling Disclosure Regime' (March 2010) 6; FSA, 'Short Selling Discussion Paper 09/1' (2009) 27.

¹⁵ Impact Assessment (n 12) 56.

¹⁶ Ibid 28. Further, flagging only provides pre-trade information and some orders may not be executed.

¹⁷ CESR, 'Report: Model for a Pan-European Short Selling Disclosure Regime' (n 14) 6. This is because regulators may lack the data to identify individual short sellers.

¹⁸ FSA (n 14) 27; CESR, 'Report: Model for a Pan-European Short Selling Disclosure Regime' (n 14) 6. The FSA also noted that equivalent data was already available to a large extent in the UK through the use of stock lending data, although it recognised that it was an imperfect proxy for the level of

Finally, there are significant costs associated with such requirements and these costs are placed both on the market participants and the entity aggregating the short positions.¹⁹ Brokers would be required to change their systems to flag clients' short sales and this would affect a significant number of brokers. Indeed quantitative estimates provided by three large UK stockbrokers suggested an average one-off compliance cost per broker of £750,000.²⁰ Further, there would then be costs in relation to aggregating and disclosing the information.²¹ The FSA concluded the costs would be far higher than those involved with disclosing individual short positions.²²

With these points in mind, although the Commission and the Parliament both supported the inclusion of marking and aggregation requirements, they met with opposition in the Council and the proposals were dropped from the final legislation.²³ Indeed the considerable costs involved in making the necessary changes to trading systems weighed heavily against the benefits of such requirements along with concerns it could drive business out of trading venues.²⁴ This is particularly true given

short selling, see further FSA (n 14) 27. However in jurisdictions where such information was not available, this data would add value.

¹⁹ FSA (n 14) 28.

²⁰ Ibid 28 and Annex 3.

²¹ On the basis of four quantitative responses received, the FSA calculated that there would be one-off costs per trading platform of £40,000, plus monthly compliance costs of approximately £3000 per platform. See further *ibid* Annex 3, 7-8.

²² Ibid 28 and Annex 3. The Commission also reiterated this, see further Impact Assessment (n 12) 56.

²³ See e.g. Council of the European Union, *Presidency Compromise* (19 November 2010) 2. The Regulation's recitals noted that the Commission should consider, in the context of its revision of MiFID, whether inclusion by investment firms of information about short sales in transaction reports would provide useful supplementary information to enable competent authorities to monitor levels of short selling. The MiFID revisions now include new rules concerning reporting transactions in financial instruments admitted to trading venues (which now covers regulated markets, MTFs and a 'catch all' organised trading facility ('OTF')) and such post-transaction reports must include a short selling flag.

²⁴ Ibid 2.

that at the time the EU rules were being considered, only Greece and Poland had the infrastructure in place to implement such a regime.²⁵ Further, as the Proposal did not envisage uniform marking requirements across EU trading venues, this would also have limited the benefit of such rules. It would also have further increased costs for market participants as they could have been faced with different requirements throughout the EU. Notably, as we will observe further below, this has also been the main problem in practice with the implementation of the individual reporting rules.

5.2.1.2 Two-Tier Reporting Rules

The Regulation instead focuses on individualised reporting rules and seeks to tackle perceived transparency deficiencies through the introduction of a two-tier private and public reporting regime at initial and incremental thresholds triggered by the size of an individual ‘net short position’. A person’s net short position is defined as the position that remains after deducting any long position that a person holds from any short position in relation to a company’s issued share capital.²⁶ A short position is defined as a short sale²⁷ of a share issued by a company, or entry into a transaction

²⁵ Impact Assessment (n 12) 56.

²⁶ Regulation 236/2012, art 3(4). Note that article 2(1)(h) of the Regulation provides that ‘issued share capital’ means the total of ordinary and any preference shares issued by the company but excludes convertible debt securities. ESMA confirmed that the definition includes all classes of shares, regardless of whether or not they have voting rights attached to them, see ESMA, ‘Questions and Answers: Implementation of the Regulation on Short Selling and Credit Default Swaps (2nd Update) 2013/159’ (January 2013), Question 3f.

²⁷ Regulation 236/2012, art 2(b) defines a ‘short sale’. In relation to shares, it means the sale of the share that the seller does not own at the time of entering into the agreement to sell, including a sale where at the time of entering into the agreement to sell, the seller has borrowed or agreed to borrow the share for delivery at settlement. It does not include a sale under a repurchase agreement; a transfer of securities under a securities lending agreement, or entry into a futures contract or other derivative contract where it is agreed to sell securities at a specified price at a future date. See also Commission Delegated Regulation (EU) 918/2012 supplementing Regulation No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps with Regard to Definitions, the Calculation of Net Short Positions, Covered Sovereign Credit Default Swaps, Notification Thresholds, Liquidity Thresholds for

which creates or relates to a financial instrument other than the company share where the effect or one of the effects of the transaction is to confer a financial advantage on the person entering into the transaction in the event of a decrease in the price or value of the share.²⁸ The rules therefore encompass direct and indirect positions, including those created through the use of derivatives.²⁹ The concept of a long position is also correspondingly wide.³⁰

The two-tier system was based on CESR's earlier model and also benefitted from some prior experience of reporting requirements imposed by national regulators during the financial crisis. Nevertheless it should also be recognised that CESR based its model on very limited empirical evidence.³¹ In particular its decision to impose a public disclosure threshold commencing at 0.5 per cent was mainly linked to the fact that the public threshold should be higher than the 0.25 per cent threshold level imposed by many regulators on financial sector shares during the crisis.³² With this in mind many remained unconvinced of the rationale for operating a permanent short selling disclosure regime in the absence of a more rigorous impact assessment and

Suspending Restrictions, Significant Falls in the Value of Financial Instruments and Adverse Events [2012] OJ 274/1, art 3(1).

²⁸ Regulation 236/2012 arts 3(1)(a)-(b).

²⁹ Note that Delegated Regulation 918/2012, Annex I, Part 1 contains a list of financial instruments that constitute indirect long positions and can constitute indirect short positions (options, futures etc.). Ibid art 7(a) also provides that cash settlement or physical delivery of underlying assets is irrelevant for the purposes of calculation of the net short position (i.e. on the expiry or exercise of e.g. a futures contract the seller can deliver the underlying asset to the buyer or provide payment in cash).

³⁰ Regulation 236/2012 art 3(2). It includes both holding a share issued by a company, and also entering into a transaction that creates or relates to a financial instrument where the effect or one of the effects of the transaction is to confer a financial advantage on the person in the event of an increase in the price or value of the share.

³¹ CESR, 'CESR Proposal for a Pan-European Short Selling Disclosure Regime' (n 5) 10-11; Moloney (n 3) 548.

³² CESR, 'CESR Proposal for a Pan-European Short Selling Disclosure Regime' (n 5) 10.

cost-benefit analysis, and feedback to CESR's model rightly suggested 'significant disquiet at the lack of empirical evidence'.³³

5.2.1.3 Article 5: Private Notification

Turning to the precise requirements, article 5 of the Regulation provides that a natural or legal person who has a net short position in relation to the issued share capital of a company that has shares admitted to trading on a trading venue shall notify the relevant NCA where the position reaches 0.2 per cent of the issued share capital and each 0.1 per cent increment above that (for example at 0.3 per cent and 0.4 per cent). A notification must also be made if the position falls below the relevant threshold.³⁴ A trading venue is defined as a regulated market or multilateral trading facility ('MTF')³⁵ and the relevant NCA for shares is defined as the NCA of the Member State where the share was first admitted to trading on a regulated market or trading venue.³⁶

5.2.1.4 Article 6: Public Disclosure

³³ Moloney (n 3) 548; CESR, 'CESR Proposal for a Pan-European Short Selling Disclosure Regime: Feedback Statement' (CESR10/089 March 2010) 4.

³⁴ Regulation 236/2012, arts 5(1)-(2).

³⁵ Ibid art 2(1)(l). Note that the definition of trading venue does not appear to have been extended to encompass the new category of organised trading facilities under the revised market abuse rules.

³⁶ Ibid art 2(1)(j)(v); Commission Regulation No 1287/2006 of 10 August 2006 Implementing Directive 2004/39/EC as Regards Record-Keeping Obligations for Investment Firms, Transaction Reporting, Market Transparency, Admission of Financial Instruments to Trading, and Defined Terms for the Purposes of That Directive [2006] OJ L 241/1 art 9(2). Note that under article 5(4) the Commission may modify these thresholds taking into account developments in the financial markets.

Article 6 of the Regulation provides that a person who has a net short position in relation to the issued share capital of a company that has shares admitted to trading on a trading venue shall disclose details of that position to the public where the position reaches 0.5 per cent of the issued share capital and each 0.1 per cent increment above that. Disclosure must also be made if the position falls below the relevant threshold.³⁷

5.2.1.5 Method of Notification and Disclosure

Article 9 of the Regulation provides that any notification or disclosure shall set out details of the identity of the person who holds the position, the size of the relevant position, the issuer in relation to which the position is held and the date on which the position was created, changed or ceased to be held.³⁸ The relevant time for calculation of a net short position shall be at midnight at the end of the trading day on which the person holds the relevant position and the notification or disclosure shall be made not later than at 15.30 on the following trading day.³⁹ Article 9(2) also provides that the time specified shall be calculated according to the time in the Member State of the relevant NCA to whom the relevant position must be notified.

³⁷ Regulation 236/2012, arts 6(1)-(2). Again, under article 6(4) the Commission can modify the thresholds to take account of developments in the financial markets

³⁸ A notification of a net short position in shares made under article 5(1) of the Regulation is to include the standardised information specified in art 2, Table 1 of Annex I, and take the format set out in Annex II of Commission Delegated Regulation (EU) No 826/2012 of 29 June 2012 supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council with Regard to Regulatory Technical Standards on Notification and Disclosure Requirements with Regard to Net Short Positions, the Details of the Information to Be Provided to the European Securities and Markets Authority in Relation to Net Short Positions and the Method for Calculating Turnover to Determine Exempted Shares [2012] OJ L251/1. A public disclosure of a net short position in shares shall also contain the standardised information specified in art 3 and Table 2 of Annex I *ibid*.

³⁹ Regulation 236/2012, art 9(2).

Article 9(3) of the Regulation provides that the private notification of information to a NCA shall ensure the confidentiality of the information. In relation to public disclosure, article 9(4) states that this shall be made in a manner ensuring fast access to information on a non-discriminatory basis. Article 9(4) also provides that the information shall be posted on a central website operated or supervised by the relevant NCA and the NCAs shall communicate the address of the website to ESMA, which in turn shall put a link to all such central websites on its own website.⁴⁰

5.2.1.6 Net Short Positions

The Regulation's reporting rules have a broader ambit than the permanent short sale restrictions and cover both direct and indirect short positions, including those created through the use of derivatives. If reporting rules are to be implemented, the inclusion of both direct and indirect positions is valuable.⁴¹ Specifically all transactions in financial instruments that create an economic exposure to a company's issued share capital should be included to provide a more comprehensive picture to NCAs and to reduce the likelihood of short sales migrating off-exchange or to derivatives.

As observed, to calculate a net short position in a company, a person must net off any long and short positions it holds in relation to a company's issued share

⁴⁰ Implementing Regulation 827/2012 also provides further detail on the means by which the information may be disclosed to the public, see further Commission Implementing Regulation (EU) 827/2012 of 29 June 2012 Laying Down Implementing Technical Standards with Regard to the Means for Public Disclosure of Net Position in Shares, the Format of the Information to Be Provided to ESMA in Relation to Net Short Positions, the Types of Agreements, Arrangements and Measures to Adequately Ensure That Shares or Sovereign Debt Instruments Are Available for Settlement and the Dates and Period for the Determination of the Principal Venue for a Share According to Regulation No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L251/11, art 2.

⁴¹ See e.g. IOSCO, 'Regulation of Short Selling, Final Report' (June 2009) 13.

capital.⁴² In the calculation, a person must consider all classes of share issued by the company (ordinary, preference etc.). Delegated Regulation 918/2012 also provides that the calculation must take into account transactions in all financial instruments, whether on or outside a trading venue, that confer a financial advantage in the event of a change in price or value of the share.⁴³ This means that the rules encompass short positions accumulated over-the-counter provided that the net short position is created with respect to shares admitted to trading on a trading venue in the EU.⁴⁴

Delegated Regulation 918/2012 also provides that indirectly holding a share through a basket of shares, and a short sale through a basket of shares, shall be taken into account in the calculation to the extent the share is represented in the basket.⁴⁵ Likewise, shares held indirectly by way of any index, or in any exchange-traded fund ('ETF')⁴⁶ or similar entity are also to be taken into account and positions shall be calculated taking into account the weight of that share in the underlying basket, index or fund.⁴⁷ The calculation shall be determined on a 'look through' basis, by the person acting reasonably having regard to publicly available information as to the composition of the relevant index or basket of securities or of the interests held by the

⁴² Delegated Regulation 918/2012 also notes that short positions on financial instruments subject to a claim to unissued shares, and subscription rights, convertible bonds, and other comparable instruments shall not be considered as short positions when calculating a net short position, see Delegated Regulation 918/2012, art 7. This is because ownership of these financial instruments is not considered a long position under the Regulation, see Regulation 236/2012, art 3(2)(b); ESMA, 'Questions and Answers: Implementation of the Regulation on Short Selling and Credit Default Swaps (2nd Update) 2013/159' (n 26) Question 3c.

⁴³ See Delegated Regulation 918/2012, art 10(1)-(3).

⁴⁴ Rodolphe Baptiste Elineau, 'Regulating Short Selling in Europe after the Crisis' (2012) 8 *International Law & Management Review* 61, 72. For instance one could enter into a derivative contract on or off exchange and obtain an economic advantage if the share price of the issuer fell.

⁴⁵ Delegated Regulation 918/2012, arts 5-6.

⁴⁶ For further details, see Appendix 4. See also further ESMA, 'Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263' (April 2012) 60.

⁴⁷ Delegated Regulation 918/2012 Annex II, Part 1, art 10(3).

relevant ETF or similar entity.⁴⁸ Finally, Delegated Regulation 918/2012 also specifies the method for calculating net short positions in relation to investment fund management activities (i.e. the discretionary management of investments on behalf of investors), and for groups.⁴⁹

5.2.1.7 Exemptions

As we observed in Chapter 1, the Regulation has extra-territorial effect, and the reporting requirements apply to persons domiciled or established within the EU or in a third country provided the shares are admitted to a trading venue.⁵⁰ However, if the principal venue for the trading of the shares is a third country rather than the EU, the transparency obligations shall not apply.⁵¹ The principal trading venue for a share is determined by turnover, and the relevant NCA shall calculate the turnover using the

⁴⁸ Regulation 236/2012, art 3(3). See also ESMA, ‘Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263’ (n 46) 14. Note that Delegated Regulation 918/2012 also sets out the method of calculation of net short positions in relation to shares. It provides that the ‘delta-adjusted model’ shall be used for calculating the net short position. ‘Delta’ indicates how much a financial instrument’s theoretical value is expected to move in case of an underlying instrument’s price variation, and Annex II of Delegated Regulation 918/2012 provides that any derivative and cash positions shall be accounted for on a delta-adjusted basis with cash positions having delta 1. The net short position in a derivative or cash position shall then be calculated by netting the long and short delta-adjusted positions in a given issuer.

⁴⁹ Delegated Regulation 918/2012 art 12. Actively managed funds are excluded from the calculation of the net short position of an investor who participates in the fund capital: rather it is the fund manager who calculates and reports any net short position. The management entity shall aggregate the net short positions of the funds and portfolios under its management for which the same investment strategy is being pursued in relation to a particular issuer. Article 13 of Delegated Regulation 918/2012 sets out the method of calculating positions for a group that has long or short positions in relation to an issuer. Although the net short position shall be calculated at the level of each individual entity within a group, at the group level the net short and long positions of all the legal entities within the group are also required to be aggregated and netted against each other. Provisions also exist to avoid the risk of double reporting by the individual entity and the group.

⁵⁰ Regulation 236/2012, art 10. The international nature of the Regulation is illustrated in the ESMA Evaluation where more than 80 per cent of all reported short positions were held by entities domiciled in the UK or the US, see ESMA, ‘Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps’ (June 2013) 59.

⁵¹ Regulation 236/2012 art 16(1). See ESMA, ‘Questions and Answers: Implementation of the Regulation on Short Selling and Credit Default Swaps (2nd Update) 2013/159’ (n 26) Question 1d.

‘best available information’⁵² and will determine whether the principal venue is located in a third country.⁵³ An exemption also exists for market-making activities or for the purposes of market stabilisation.⁵⁴

5.2.1.8 ESMA

Separately, NCAs shall also provide information in summary form to ESMA on a quarterly basis on net short positions relating to issued share capital for which it is the relevant NCA and receives notifications under article 5.⁵⁵ Further, in exceptional circumstances ESMA can require persons who have net short positions in relation to a specific financial instrument or class of instrument to notify a NCA or disclose to the public details of any such position.⁵⁶ There are also notification and disclosure powers for NCAs in exceptional circumstances, although these apply to financial instruments not already covered by the article 5-8 transparency obligations that include shares,

⁵² Commission Delegated Regulation (EU) 826/2012 of 29 June 2012 supplementing Regulation (EU) 236/2012 with Regard to Regulatory Technical Standards on Notification and Disclosure Requirements with Regard to Net Short Positions, the Details of the Information to Be Provided to the European Securities and Markets Authority in Relation to Net Short Positions and the Method for Calculating Turnover to Determine Exempted Shares [2012] OJ L 251/1, art 6(2) provides that as far as reasonably possible a NCA should use publicly available information in preference to other sources. See also Implementing Regulation 827/2012, arts 9-11 that provides for the dates and periods to be used for the calculations.

⁵³ Regulation 236/2012, art 16(2). See also Delegated Regulation 826/2012, art 6 that sets out the method of calculation of turnover. NCAs must run this calculation at least every two years and if the principal trading venue is located in a third country, the NCA must notify ESMA who will update and publish a list of exempted shares.

⁵⁴ Regulation 236/2012, arts 17(1) and (4). See also discussion in Chapter 4 with respect to the scope of the market-making exemption and NCA non-compliance with ESMA’s guidelines.

⁵⁵ Ibid art 11(1). Delegated Regulation 826/2012, art 4 sets out the details of the information to be provided to ESMA and Implementing Regulation 827/2012, art 3 seeks to standardise the format of the periodic information.

⁵⁶ Regulation 236/2012, art 28(1)(a).

sovereign debt, and sovereign CDSs.⁵⁷ Finally, as observed in Chapter 4, ESMA may take such a decision if the measures address a threat to the orderly functioning and integrity of financial markets or the stability of the EU's financial system, there are cross-border implications, and no NCA has taken measures to address the threat or one or more NCAs have taken measures that do not adequately address the threat.⁵⁸

5.2.2 Comments

5.2.2.1 Notification to Regulators

Those who responded to the Commission's public consultation on its Proposal (the 'Consultation') were broadly in favour of private notifications of individual net positions,⁵⁹ and such confidential reports can in principle offer benefits to regulators. For instance they offer a means of tracking short selling activities on the markets and should help provide early warning signs to regulators concerning both the build up of, and who holds, a short position, enabling any necessary follow up enquiries to then take place with a market participant.⁶⁰ This could, in principle, help deter and

⁵⁷ Ibid art 18. Hence such reports could include for instance short positions in corporate bonds and corporate CDSs, see Oskari Juurikkala, 'Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis' (2012) 9 ECFR 307, 320.

⁵⁸ Regulation 236/2012, art 28(2). See Chapter 4, section 4.4.3 for a discussion as to the controversy surrounding ESMA's new intervention powers.

⁵⁹ Out of 105 publicly accessible English responses on the Commission's website in English, approximately 72% of those responses were supportive of notification to regulators. Breaking this down, approximately 80% of registered organisations, 72% of public authorities and 64% of individual contributions supported this option. See further Commission, 'Consultation on Short Selling' (2010) <http://ec.europa.eu/internal_market/consultations/2010/short_selling_en.htm> accessed 8 August 2013.

⁶⁰ FSA (n 14) 29.

constrain particularly aggressive and large-scale short selling that could be perceived to constitute a threat to the orderly functioning of markets.⁶¹

Nevertheless, as we have observed, this option could be ineffective in practice as it is unlikely that ‘abusive’ short sellers will inform NCAs of manipulative behaviour. Rather NCAs may end up receiving numerous notifications from ‘honest’ market participants (and this will also prove costly for such participants),⁶² and so will not help assist NCAs with respect to tackling manipulative behaviour. Further, even if such notifications do help NCAs with respect to punishing abusive behaviour, the fines levied are unlikely to act as a sufficient deterrent.

Indeed, this is also particularly the case when one takes into account the Regulation’s enforcement regime. As we observed in Chapter 1, this is one of the Regulation’s particular weak points as it relies on the pre-crisis ‘less articulated model’ whereby penalties are not harmonised and it is up to Member States to establish rules on penalties and administrative measures applicable to infringements.⁶³ In practice this ‘go-it-alone’ approach means that penalties for infringements vary considerably between Member States (for instance in Estonia, monetary fines for

⁶¹ CESR, ‘Report: Model for a Pan-European Short Selling Disclosure Regime’ (n 14) 5-6. Further, the decision to require notification of net rather than gross positions should be welcomed. Gross position reporting may not provide such an accurate picture or reflect the true market exposure.

⁶² Indeed there will be both one-off and on-going compliance and administrative costs for investors associated with these requirements. For instance a survey conducted by the FSA of 28 firms with short selling activities and three trade associations estimated that the one-off compliance costs would be approximately £50,000 per firm and on-going costs would be approximately £7,000 per month per firm. The cost estimates were based on a threshold of 0.25% and disclosure for every position change above this, see further FSA (n 14) Annex 3, 8-9.

⁶³ Moloney (n 3) 570, 967. It is recognised however that there could also be sanctions levied under the relevant market abuse legislation. Separately, note that the broader position with respect to enforcement and sanctions is now changing following the crisis with some of the later post-crisis reforms (including the recent market abuse reforms) now adopting a much more prescriptive approach to sanctions.

legal persons shall be up to 32,000 euro whereas in France fines can be up to 100 million euro or ten times the amount of profit made) meaning the rules may prove ineffective in practice.⁶⁴ Further, even though ESMA is empowered to adopt guidelines to ensure a consistent approach is taken to the establishment of penalties by Member States, at the time of writing it had not done so.

Next, turning to examine the Regulation's notification thresholds, the triggers of 0.2 per cent and each 0.1 per cent increment will be quickly crossed, especially by funds focusing on small market capitalisation entities. Consequently, such low thresholds also run the risk of overwhelming regulators with responses. Further, as the requirements apply to all firms and not purely to financial sector firms, this could create a lot of 'white noise' making it very difficult for regulators to draw sensible conclusions from the data.⁶⁵ Indeed, amid the noise there may also be some important and useful flags for regulators that simply go unnoticed.⁶⁶ Market participants reiterated these concerns to ESMA: for example some considered the thresholds to be too low,⁶⁷ and some perceived the increments to be too narrow and require more reporting than was useful.⁶⁸

Consequently, in the event the rules remain in place, it would be preferable to limit their ambit. For instance the rules could be restricted either to situations where

⁶⁴ ESMA, *List of Administrative Measures and Sanctions Applicable in Member States to Infringements of the Short Selling Regulation* (n 2).

⁶⁵ See e.g. CFA, *CFA Society of the UK: Response to EC Public Consultation on Short Selling* (10 July 2010) 4.

⁶⁶ See further AIMA, *CESR Consultation Paper on the Proposal for a Pan-European Short Selling Disclosure Regime* (2009) 3.

⁶⁷ E.g. AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (15 March 2013); Deutsche Bank, *ESMA Call for Evidence* (15 March 2013).

⁶⁸ E.g. Eumedion, *ESMA Call for Evidence* (15 March 2013) 2.

there was the greatest risk of market abuse occurring, such as before a seasoned equity offering ('SEO'),⁶⁹ or where there was a perceived risk of disorderly markets occurring, for example in relation to leading financial sector securities.⁷⁰ Further, in a similar vein to the Regulation's provisions that permit ESMA to require disclosure in emergency situations, the rules could also enable regulators to require notifications on an ad hoc basis.⁷¹ Such an approach would enhance the quality of the information being received by regulators and would also reduce investors' on-going costs. It would also eliminate the need to have permanent thresholds that risk generating an excess of information.

5.2.2.2 Disclosure to the Market

Turning to the public disclosure requirements, these rules are particularly problematic.⁷² As already observed, these requirements were introduced due to the risk of information asymmetries between short sellers and less informed market participants. The Commission considered that disclosing significant short positions would provide useful information to other market participants about price movements that short sellers expect and this could improve the efficiency of price discovery, if

⁶⁹ The FSA considers that firms undertaking SEOs could be susceptible to short selling's negative effects. For further discussion see further Chapter 2, section 2.3.1.

⁷⁰ See HFSB, *Consultation Response to the CESR Proposal for a Pan-European Short Selling Disclosure Regime* (2009) 4-5.

⁷¹ Ibid 4-5. Indeed this could, for example, be based on the SEC's existing system of electronic blue sheets where it requests broker-dealers to submit information connected with investigations, see further section 5.3.1.2 below.

⁷² It should also be recognised here that the Commission introduced this option despite noting that it was strongly opposed by a significant number of market participants to its Consultation. Indeed, in relation to the 105 publicly available English responses to the Consultation, only approximately 25% were in favour of public disclosure, see further Commission, 'Consultation on Short Selling' (n 59). Breaking the figures down, only 29% of registered organisations that responded were in favour of this option (although notably those in favour included European Issuers that represents the interests of issuers in Europe), plus 39% of public authorities, and 14% of individual contributions.

correctly interpreted.⁷³ However this potential benefit needs to be carefully balanced against the serious drawbacks that may result from such disclosures. Indeed, aside from the direct compliance costs, that will be similar to the costs we have already observed in relation to notifying positions to regulators, there are also a number of indirect concerns.

First, as public disclosure will identify short sellers, this may significantly reduce the overall level of short selling and will lead to lower trading volumes: a reduction in market liquidity.⁷⁴ This will stem both from the extra costs to short sellers in having to disclose short positions to the market, and through the cost to them in terms of competitive disadvantage in revealing their trading strategies.⁷⁵ Indeed, market participants highlighted to ESMA that there had been observed changes to trading behaviour in order to remain under the 0.5 per cent public threshold.⁷⁶ Further, public disclosure will also enable other market participants to act

⁷³ Impact Assessment (n 12) 29-30.

⁷⁴ See e.g. Oscar Bernal, Astrid Herinckx and Ariane Szafarz, 'Which Short-Selling Regulation Is the Least Damaging to Market Efficiency? Evidence from Europe' (2014) 37 *International Review of Law and Economics* 244 that assessed the impact on stock returns of prohibitions on short selling and disclosure requirements of short positions implemented in the EU since September 2008. The study looked at 14 jurisdictions in the EU where short sales took place and daily stock information is available. The study looked at the period from 1 July 2008 – 30 June 2009 and found that disclosure requirements to the regulator or the market reduced trading volumes and raised volatility. See also e.g. Oliver Wyman, 'The Effects of Short Selling Public Disclosure of Individual Positions on Equity Markets' (February 2011) 32 that found that the effect of public disclosure requirements on UK financial equities was a reduction in trading volumes. This study examined 20 UK financial services equity securities subject to the UK's pre-Regulation disclosure regime that required public disclosure of short positions in financial sector firms crossing a particular threshold. For more information on the FSA's pre-Regulation disclosure regime, see footnote (n 96) and accompanying text below.

⁷⁵ Bernal, Herinckx and Szafarz (n 74) 246. Bernal et al. also found that disclosure requirements increased intra-day volatilities.

⁷⁶ ESMA (n 50) 12. Indeed ESMA also noted that investors were averse to crossing the public disclosure threshold of 0.5 per cent. It noted that only 14.5 per cent of positions held below the 0.5 per cent threshold moved above the threshold, among which half crossed back, see further *ibid* 13. Further, it noted that only one fourth of the positions reported close to the 0.5 per cent threshold and above 0.4 per cent crossed the public disclosure threshold.

unfairly as ‘free riders’,⁷⁷ thereby reducing the profits of those who had conducted the research. Thus it will reduce the incentives to conduct the research in the first place and this will harm price discovery.⁷⁸

Further, public disclosure by an influential short seller may result in ‘herding’ behaviour, whereby other poorly informed investors make decisions based on imitation and follow the short seller, seeking to profit by ‘jumping on the bandwagon’.⁷⁹ As such behaviour reinforces the price tendency, public disclosure risks exacerbating a downward price spiral, exactly the effect the disclosure rules are seeking to prevent. Alternatively, individual market participants may also suffer from others who exploit the information that has been made publicly available to manipulate the share prices in order to create a ‘short squeeze’.⁸⁰

Turning to the public disclosure threshold, it is again clear that the 0.5 per cent threshold triggering public disclosure will be quickly reached, particularly for funds that focus investments in entities with small and mid market capitalisations.⁸¹ Indeed

⁷⁷ A free rider benefits from a resource without having to pay for the cost of the benefit.

⁷⁸ Assosim, *European Commission Public Consultation on Short Selling* (July 2010) 2.

⁷⁹ Juurikkala, 318. In fact, public disclosure may in fact mislead the public as disclosure can create the impression that a share price is declining when in fact the short position may for example simply be a hedge to offset the exposure to a long position, see further e.g. Managed Funds Association, *Managed Funds Association Response to the European Commission's Proposals Relating to Short Selling* (July 2010) 5.

⁸⁰ For ‘short squeeze’ definition, see Appendix 4; FSA (n 14) 7.

⁸¹ With this in mind see e.g. Emiliios Avgouleas, ‘The Vexed Issue of Short Sales Regulation When Prohibition Is Inefficient and Disclosure Insufficient?’ in Kern Alexander and Niamh Moloney (eds), *Law Reform and Financial Markets* (Edward Elgar 2011) 105-106 who suggests that you could adjust disclosure thresholds according to the liquidity of the shares.

such a low threshold, especially in relation to less liquid shares, could also result in adverse market practices already observed, such as the danger of a short squeeze.⁸²

Likewise, disclosure at such low thresholds could particularly accentuate the likelihood of herding behaviour, again increasing the risk of disorderly markets.⁸³ In this regard the current asymmetry between short and long position disclosures should also be noted. It should first be observed that the long position disclosure requirements serve a different aim from the short position disclosures, stemming from a mergers and acquisition perspective and seeking to enhance transparency surrounding who controls a company.⁸⁴ Nevertheless it is notable that the public disclosure requirements for long interests also commence at a considerably higher threshold than for short positions (in the UK for instance, the reporting requirements generally commence when a shareholder's percentage of total voting rights reaches, three per cent and each one per cent increase thereafter).⁸⁵

Specifically with respect to herding concerns, the inconsistency between these two sets of disclosures is unhelpful. In particular short position disclosures commencing at such a low threshold followed by repeated disclosures will quickly demonstrate that the market is repeatedly going short on a security. This may increase herding and exacerbate rather than reduce volatility, contrary to the legislator's intention.⁸⁶ Indeed as regulators' now maintain that short selling conveys a signal that

⁸² See BBA, *European Consultation on Short Selling: A Response by the British Bankers' Association* (July 2010) 5.

⁸³ *Ibid* 5.

⁸⁴ FSA (n 14) 31.

⁸⁵ Disclosure and Transparency Rules ('DTRs'), DTR 5.1.2 and 5.8.1. The level is five per cent for passive investors.

⁸⁶ BBA (n 82) 5.

a security is overvalued,⁸⁷ it could be argued that they are in fact implicitly telling market participants that short sellers have better information than those purchasing the stock, and are actually inadvertently encouraging herding based on the short selling behaviour.⁸⁸ With this in mind, the current asymmetry of the long and short disclosures is particularly problematic as it only accentuates such risks.

Given the benefits that short selling brings to markets that we observed in Chapter 2,⁸⁹ the numerous issues with public disclosure should be of particular concern: lower trading activity will hamper price adjustments and will affect the functioning of efficient markets.⁹⁰ Indeed, due to the costs associated with public disclosure, and the low thresholds imposed, short sellers may simply be unwilling to hold disclosable short positions. Instead they may seek other mechanisms to achieve their aim: for example they may choose to be less active in EU markets and migrate to more liberal markets rather than having their trading strategies undermined by public disclosure.⁹¹ Based on the responses to ESMA, such concerns are not purely

⁸⁷ FSA (n 14) 24.

⁸⁸ HFSB (n 70) 2-3.

⁸⁹ See e.g. Chapter 2, section 2.2.1.

⁹⁰ It should be noted that although Bernal et al's research also suggested that bid-ask spreads seemed to improve with transparency requirements, the authors stressed that notwithstanding this benefit, public disclosure requirements still raised privacy concerns and could seriously damage trading activity. See further Bernal, Herinckx and Szafarz (n 74) 235; Alessandro Beber and Marco Pagano, 'Short-Selling Bans around the World: Evidence from the 2007–09 Crisis' (2013) 68 J Fin 343, 361. Indeed it should be recognised that although transparency requirements may have a beneficial effect on spreads, this measure essentially only relates to transaction costs, which in terms of priority in financial theory ranks below the fair valuation of securities and high trading volumes. See further e.g. Bernal, Herinckx and Szafarz (n 74) 253. It is therefore suggested that public disclosure requirements should still be viewed with scepticism due to the negative impact of such requirements on both trading volumes and price discovery.

⁹¹ Indeed this could distort the market and increase the risk of price bubbles, see further AIMA (n 66) 10;

theoretical: changes to trading behaviour have been observed that include the allocation of capital to markets outside Europe.⁹²

This outcome, which cannot have been the intention of the regulators, will clearly have a detrimental effect on EU markets relative to other markets.⁹³ Thus although the Regulation stated in its preamble that the requirements imposed by it should address the identified risks ‘without unduly detracting from the benefits that short selling provides to the quality and efficiency of markets’,⁹⁴ it is evident that the imposition of individual public disclosure obligations amount to a de facto short selling restriction above the public disclosure threshold and considerably impacts on the benefits short selling provides to the efficient functioning of markets.⁹⁵

However in the absence of the public disclosure rules being removed in the near future, one alternative could be to amend the rules in line with the UK’s more nuanced approach that applied prior to the Regulation’s introduction. The UK’s FSA introduced public disclosure requirements in relation to financial sector companies (encompassing direct and indirect short positions) at the same time as it imposed temporary short selling bans in 2008.⁹⁶ However, following the lifting of the bans

⁹² AIMA (n 67) 4-5; ESMA (n 46) 10-12. For instance between 1 November 2012 and 28 February 2013 out of 12603 reports, only 26% of reports were above the 0.5 per cent threshold and disclosed to the public (74% were within the 0.2-0.5 per cent notification thresholds).

⁹³ Indeed Elineau emphasises that the ‘fear that regulation will unduly interfere with market allocation of resources materialises here’, see Elineau (n 44) 75.

⁹⁴ Regulation 236/2012, recital 5.

⁹⁵ Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps’ (n 9) 3. Luca Enriques and Sergio Gilotta, ‘Disclosure and Financial Market Regulation’ in Eilis Ferran, Niamh Moloney and Jennifer Payne (eds), *The Oxford Handbook on Financial Regulation* (Oxford University Press 2014) 20.

⁹⁶ FSA, Short Selling (No 2) Instrument 2008.

and a FSA consultation,⁹⁷ it decided to continue with its public disclosure regime. Notably however, and unlike the rules subsequently introduced by the Regulation, the FSA chose to restrict the ambit of the requirements to financial sector companies and companies undertaking SEOs.⁹⁸

IOSCO

It is also worth noting at this point that by endorsing public disclosure, the Regulation also pushes at the limits of the principles on short selling put forward by IOSCO in its 2009 short selling report. Although IOSCO's second principle stated that short selling should be subject to a reporting regime that provides timely information to the market or to market authorities, IOSCO also acknowledged the problems that existed with respect to disclosure to the market. It noted that such disclosures could mislead the market, would expose short sellers, and could subject them to potential short squeezes.⁹⁹ Further, IOSCO also stated that it recognised the difficulties in assessing the correct balance between the benefits and potential drawbacks of any transparency regime.¹⁰⁰ With this in mind, with the choices it has made, the EU has essentially failed to find the correct balance with its choice of rules.

5.2.2.3 Timing

⁹⁷ FSA, *Temporary Short Selling Measures Consultation Paper 09/1* (2009).

⁹⁸ See FSA, 'Financial Stability and Market Confidence Sourcebook' (2010) section 2.2.

⁹⁹ IOSCO (n 41) 11-12.

¹⁰⁰ Ibid 11. Indeed IOSCO also noted that setting the threshold of short sale reporting too low could be overly burdensome for those responsible for reporting, see *ibid* 14.

Turning to the timing requirements, imposing a tight reporting schedule on short sellers will create a significant obligation in terms of compliance.¹⁰¹ However in the event that the information being reported is to be of any value, it needs to be released as soon as possible so that regulators and market participants can make informed decisions on whether any action is warranted on their part.¹⁰² IOSCO reiterates the importance of prompt reporting in its second principle on short selling, stating that short selling should be subject to a reporting regime that provides ‘timely’ information to the market or market authorities.¹⁰³ IOSCO also states that reporting should be done as soon as practicable and that the time lag between the creation of the position and the reporting should be ‘as short as possible’.¹⁰⁴

As we have observed, the Regulation provides that the relevant time for the calculation will be at midnight at the end of the trading day on which the person holds the relevant position, and the report is required to be made not later than 15.30 on the following trading day (‘T+1’).¹⁰⁵ On balance, considering both IOSCO’s view, and the challenges faced in accurately computing net short positions, that may involve considerable complexities in relation to indirect positions, this seems appropriate. Although there would clearly be further benefits in obtaining reports on the same day

¹⁰¹ See e.g. AIMA, *European Commission’s Public Consultation on Short Selling* (13 July 2010) 7.

¹⁰² CESR, ‘Report: Model for a Pan-European Short Selling Disclosure Regime’ (n 14) 10. See also e.g. Stephen E. Christophe, Michael G. Ferri and James J. Angel, ‘Short-Selling Prior to Earnings Announcements’ (2004) 59 *J Fin* 1845. Christophe et al advocated more timely disclosures of short selling to reduce the potential for insider dealing. It should be noted however that this was directed at the US where the publicly available information on short selling at that time was limited to only monthly reports of short interest in individual stocks.

¹⁰³ IOSCO (n 41) 10.

¹⁰⁴ *Ibid* 14.

¹⁰⁵ Regulation 236/2012, art 9(2).

that any relevant threshold is crossed,¹⁰⁶ attempting to further tighten the Regulation's requirements is likely to prove impossible in practice for those making the reports.

5.2.2.4 Basis for Calculation

Moving to the basis for calculating short positions, as already observed, the inclusion of direct and indirect positions, whether exchange-traded or OTC, should be supported. However, given that short positions held indirectly through baskets, indices, or ETFs tend to be used for general hedging purposes rather than to express negative sentiment in relation to an individual share, it would perhaps seem sensible for the Regulation to consider applying a 'de minimis' threshold to such positions.¹⁰⁷ This would mean that a position held in a security that represented part of an index or basket would only be included in a calculation if the security had, for instance, a respective weight of 20 per cent or more or if the index or basket was not sufficiently diversified.¹⁰⁸ Such an approach would also help reduce market participants' compliance burden given that monitoring and calculating such short positions can be costly and time consuming. Indeed, those responding to ESMA doubted whether the current system led to meaningful information being produced for either regulators or market participants.¹⁰⁹ Indeed introducing a de minimis requirement for baskets,

¹⁰⁶ For example this would capture intra-day positions that breach a threshold and then return below it before the end of the trading day, see CESR, 'CESR Proposal for a Pan-European Short Selling Disclosure Regime' (n 5) 13.

¹⁰⁷ Eumedion (n 68) 3-4.

¹⁰⁸ ESMA, 'Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263' (n 46) 70.

¹⁰⁹ E.g. Eumedion (n 68) 3-4.

indices, and ETFs would also be in line with the approach taken in the Transparency Directive in relation to disclosure of such long positions.¹¹⁰

In its Evaluation, ESMA proposed some limited amendments that included facilitating easier access to information on indices.¹¹¹ However, it was unwilling to consider introducing a de minimis regime, and this is disappointing: this would likely produce more useful information, whilst alleviating the burden in terms of calculating such positions.

5.2.2.5 Reporting Mechanisms

Finally, the biggest concern highlighted in relation to the European rules in practice has been the absence of harmonisation of reporting requirements between the NCAs. Due to this, each NCA has implemented its own approach for registration and reporting, leading to multiple reporting channels and numerous differences in the specified reporting formats.¹¹² For instance the Belgian regulator requires the completion of a spreadsheet that includes a unique notification ID and also categorises notifications by type (i.e. new position, updated position etc.).¹¹³ The French rules provide that an online access account must be created, the method of which varies depending on a person's status (for instance directors of listed companies can create accounts directly while persons holding disclosable NSPs must

¹¹⁰ See e.g. DTR 5.3.3G(2).

¹¹¹ ESMA (n 50) 15.

¹¹² AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (n 67) 1.

¹¹³ Belgian Financial Services and Markets Authority, 'Short Selling' (2014) <<http://perma.cc/L254-3H4R>> accessed 25 November 2014; AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (n 67) 6-7.

contact an administrator).¹¹⁴ The Finnish regulator requires that reports must be made via protected email connection, and the British provisions specify that different email addresses should be used depending on whether it is a private or public report.¹¹⁵

This lack of standardisation creates significant operational burdens for market participants and is also contrary to the intention of achieving harmonised implementation. With this in mind, many market participants proposed creating a centralised reporting platform using a standardised format. For instance a single EU website could be used for publishing net short position disclosures, or ESMA could create a standard reporting form and specify a uniform communication method to be used by all national regulators.¹¹⁶ In line with the proposed consolidated audit trail in the US, introducing a pan-European reporting system would be more efficient and should also enhance the quality of information being received.¹¹⁷

Despite this, in its Evaluation, ESMA proposed no changes to the Regulation. In fact it appeared to be strongly swayed by the views of the regulators, who preferred the current arrangements and believed the systems to now be operating smoothly.¹¹⁸ ESMA's cautious conclusions are disappointing: the lack of harmonisation of reporting systems between NCAs is the antithesis to what the Regulation seeks to achieve. Although there would undoubtedly be costs involved in designing and

¹¹⁴ Autorité des Marchés Financiers, (2014) <<http://perma.cc/LJ7H-6DZD>> accessed 25 November 2014.

¹¹⁵ Finnish Financial Supervisory Authority, 'Notification of Short Positions' (2014) <<http://perma.cc/NNQ2-5PYJ>> accessed 25 November 2014; UK Financial Conduct Authority, 'Short Selling' (2014) <<http://perma.cc/W3UB-KHMD>> accessed 25 November 2014.

¹¹⁶ AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (n 67) 6.

¹¹⁷ Societe Generale, *Response to the ESMA Call for Evidence* (March 2013) 2.

¹¹⁸ See ESMA (n 50) 19.

implementing a new system, the end result would be far more in keeping with the Regulation's recital that stated that the obligations requiring reporting of net short positions were to be applied in a 'uniform manner' throughout the Union.¹¹⁹

In the Commission report that followed the ESMA Evaluation, it chose not to tackle the concerns observed by market participants in any detail. It simply stated that there was no need to change the thresholds or the current methodology for calculating net short positions. Further it did not support centralised reporting, stating it considered the current system of reporting at the national level was 'functioning well' and that centralised reporting did not appear to offer substantial benefits.¹²⁰ Although the reluctance to introduce changes so soon after the Regulation's introduction is understandable, the unwillingness of the Commission to fully address the concerns of market participants, or to even consider the minor technical amendments that ESMA had proposed is unhelpful. Even in the event that the Commission chooses not to remove the public disclosure obligations, it is hard to agree with its view that the current reporting set-up is functioning well.

5.2.3 Concluding Remarks

As we have observed, although the private notification obligations in the Regulation may be supported theoretically, in practice they may prove ineffective. There are also serious concerns about individualised public disclosure requirements that should not be ignored. Indeed many of these concerns are now being played out in practice with short sellers seeking to avoid public disclosure and evidence of capital being moved

¹¹⁹ Regulation 236/2012, recital 3.

¹²⁰ Commission, 'Report on the Evaluation of the Regulation on Short Selling and Certain Aspects of Credit Default Swaps' (December 2013) 2-4.

outside Europe. Further, the existing lack of harmonisation of reporting requirements between national regulators is very unhelpful: this only results in operational difficulties, confusion, and creates a risk for data quality.¹²¹

More generally, given that it has been recognised by both CESR and IOSCO that short position disclosure regimes are considered to be a ‘greenfield’ area where market authorities in many markets have limited experience, it would surely have seemed likely that changes and fine tuning would be necessary going forward.¹²² Indeed this is all the more given the limited empirical evidence that the current rules have been premised on. Nonetheless given that the existing rules look set to remain in place, at the very least the Commission could have been more receptive to alleviating some of the challenges participants face in calculating net short positions: for instance requiring the inclusion of indices and baskets only when a de minimis threshold is crossed would likely provide more meaningful information and reduce the burden on market participants.

5.3 US Transparency Requirements

Turning to consider the US rules, it should first be noted that the main difference with the EU is the lack of any individual reporting obligation. Instead the US reporting set-up includes marking requirements on sell orders of all equity securities, and also more general recording and reporting obligations. Since August 2009 there has also been an increase in publicly available reports, and the Dodd-Frank Wall Street Reform and

¹²¹ ESMA (n 50) 19.

¹²² CESR, ‘CESR Proposal for a Pan-European Short Selling Disclosure Regime’ (n 5) 11; IOSCO (n 41) 14.

Consumer Protection Act 2010 (‘the Dodd-Frank’ Act) also set out proposals concerning short sale reporting. This included a requirement for the SEC to conduct two studies in relation to short sale positions and transaction reporting. The SEC submitted its report to Congress in June 2014, ultimately concluding that none of the options were likely to be cost effective.¹²³

This section demonstrates that although short sale reporting rules form part of the US’s regulatory framework, such provisions currently perform a much smaller role, particularly in comparison with their position in the EU’s regime. Further, the rules that are in place in the US stem from a multitude of sources. Indeed, in contrast to the EU’s rules, no current data regularly provides the identities of short sellers to the SEC. With this in mind, this section suggests that the US has lessons it can learn from the EU, particularly in relation to the EU’s notification regime of individual net short positions. Although there are drawbacks to such rules that we have observed in section 5.2 above, adopting such a requirement could help increase the detailed information that is available to regulators on significant net short positions and enable it to then take enforcement action more effectively.¹²⁴

5.3.1 Non-Public Reporting Requirements

As we observed in Chapter 4, prior to the financial crisis the US already had a number of existing rules designed to regulate short selling. Regulation SHO provides a regulatory framework for short sales, and of particular relevance to this section are

¹²³ SEC, ‘Short Sale Position and Transaction Reporting Report’ (5 June 2014) 1.

¹²⁴ This is particularly the case if the penalties imposed by the SEC for violations are significant. Indeed, this could be a handy additional tool given the SEC’s particularly zealous approach to public enforcement in general (including with respect to pursuing cases of insider trading), see e.g. John Coffee, ‘Law and the Market: The Impact of Enforcement’ (2007) 156 *University of Pennsylvania Law Review* 229, 264-5.

the short sale transaction reporting requirements included in rule 200 that sets out uniform reporting requirements for sales of all equity securities,¹²⁵ whether exchange-listed, or OTC.

5.3.1.1 Regulation SHO

Rule 200(a) of Regulation SHO defines a short sale as any sale of a security that the seller does not own, or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. Rules 200(b)(1)-(6) then provide a limited range of circumstances when a person is ‘deemed to own’ a security. This includes the person or his agent having title to the security; the person purchasing or entering into a binding unconditional contract to purchase the security but not yet receiving it; and the person having an option to purchase or acquire the option and exercising the option. Rule 200(c) provides that a person shall be deemed to own securities only to the extent that he has a net long position in such securities.

Order Marking

Rule 200(g) provides that a broker or dealer must mark all sell orders¹²⁶ of any equity security as ‘long’, ‘short’ or ‘short exempt’.¹²⁷ Under rule 200(g)(1) an order to sell

¹²⁵ ‘Equity security’ is defined in rule 3a11-1 under the Securities Exchange Act 1934 (the ‘Exchange Act’). Broadly this includes any stock or similar security, any security future on any such security, and security convertibles.

¹²⁶ Rule 3b-16c under the Exchange Act defines an ‘order’ as a firm indication of willingness to buy or sell a security.

¹²⁷ For further details on the ‘short exempt’ marking, see Appendix 4. There is an exception enabling broker-dealers to disregard particular short positions in a security in relation to the calculation of net positions as ‘block positioners’ (where a broker-dealer acts as principal taking some or all of a client’s block order (i.e. a large trade) to ensure completion of a transaction that could otherwise be difficult to

shall be marked long only if the seller is deemed to own the security pursuant to rule 200 and either the security to be delivered is in the physical possession or control of the broker or dealer, or it is reasonably expected that the security will be in the physical possession or control of the broker or dealer no later than the settlement of the transaction. This further limits the possibility of marking a sell order ‘long’ as a person may be deemed to own the security being sold under rule 200 but physical possession or control or the reasonable expectation thereof in time for settlement may not be present.¹²⁸ Further, SEC guidance on rule 200(g) also currently encourages erring on the side of marking orders short.¹²⁹

Rule 200(g)(2), recently amended to reflect the introduction of the alternative uptick rule, provides that after the ten per cent circuit breaker is triggered for a security, a sale order is permitted to be marked short exempt if a broker-dealer identifies the short sale order as being at a price above the current national best bid at the time of submission.¹³⁰ An order may also be marked short exempt pursuant to the one of the narrow exceptions to the alternative uptick rule.

effect in the course of ordinary trading). See rule 200(d) Regulation SHO; SEC, ‘Short Sales, Release No. 34-50103 (Final Rule)’ (July 28, 2004) 48011.

¹²⁸ For example a person may be deemed to own the securities but there may be transfer restrictions (such as in relation to restricted securities under rule 144 of the Exchange Act) that mean the seller cannot meet the possession or control requirements. See SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 123) 32.

¹²⁹ See SEC, ‘FAQs on Regulation SHO’ (2012) Question 2.5 <<http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (<http://perma.cc/VFP2-F4MN>)> accessed 9 June 2014. For instance where a person is, for example, net long 1000 shares, and simultaneously enters multiple orders to sell 1000 shares owned, only one sale order can be marked long: the rest must be marked short. In this situation one of the orders marked short may execute first and the other orders including the long order may be cancelled such that the resulting transaction would be recorded as a short sale even though it was actually long and did not result in a short position.

¹³⁰ Note that this only permits broker-dealers to mark orders short exempt, they are not obliged to mark any orders short exempt. However broker-dealers unwilling to do so could suffer negative business consequences if clients wish to rely on this exception. See SEC, ‘Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)’ (February 26, 2010) 116-117.

Under the current rules the order marks are neither submitted nor reported to the ‘Consolidated Tape’, (the system that reports transaction information for listed securities and ETFs),¹³¹ but instead are maintained as part of the broker-dealer’s books and records.¹³²

5.3.1.2 Audit Trails: Reporting to the Financial Industry Regulatory Authority (‘FINRA’)

This section briefly considers the audit trail and trade reporting rules that are in place in the US. Although the reporting requirements (in conjunction with the marking requirements) are helpful in capturing information, there are a number of drawbacks including in relation to levels of accuracy and timeliness. With this in mind the development in the US of a consolidated audit trail system should help improve the quality of information being received by the regulator.

Order Audit Trail System

Securities exchanges, securities associations (such as FINRA), and clearing agencies are all classified as self-regulatory organisations (‘SROs’) in the US,¹³³ and SROs

¹³¹ For further details on the Consolidated Tape, see Appendix 4.

¹³² Rules 17a-3 and 17a-4 under the ‘Exchange Act. The broker then sends the order to the exchange or alternative trading facility for execution. Note however that some orders never execute so these marks are not a perfect indicator of market sentiment, see SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 123) 89.

¹³³ John Carson, ‘Self-Regulation in Securities Markets’ (World Bank Policy Research Working Paper 5542, January 2011) 6. The Securities Exchange Act 1934 (the ‘Exchange Act’) requires SROs to be recognised by the SEC and requires SROs to regulate members’ compliance with both their own rules and federal securities laws, see further *ibid* 6.

maintain their own audit trails for their members. Specifically FINRA¹³⁴ imposes its own order recording and reporting requirements under its order audit trail system ('OATS').¹³⁵ These rules impose obligations on FINRA member firms to report order information to FINRA on a daily basis.¹³⁶ For short sale orders, the broker will record the designation of the order as 'short' and report this to FINRA.¹³⁷ The rules now cover all national market system ('NMS')¹³⁸ stocks and the New York Stock Exchange ('NYSE'), and NYSE Arca replaced their requirements for members who were FINRA or Nasdaq members to enable them to satisfy their obligations by meeting the OATS requirements.¹³⁹

Trade Reporting

Once an order has been executed, a transaction report will be submitted by the broker to the exchange, or to FINRA if executed OTC. These trade reports will include identification as to whether the transaction is a short or long sale.¹⁴⁰ Separately, the SEC can request that a broker-dealer firm submit transaction data with certain

¹³⁴ FINRA, created in 2007, was designed as a monopoly SRO under the active and direct oversight of the SEC (it combined the National Association of Securities Dealers' Inc. ('NASD') and the member regulatory functions of NYSE Group Inc. ('NYSE')). It is the largest independent regulator of securities firms doing business with the public in the US. The extent of its authority is vast, overseeing nearly 4300 brokerage firms and monitoring 80 per cent of trading in US listed equity markets. See e.g. Roberta S. Karmel, 'Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies' (2008) 14 *Stan JL Bus & Fin* 151; Jonathan Macey and Caroline Novogrod, 'Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation' (2011) 40 *Hofstra L Rev* 963.

¹³⁵ FINRA rules 7410-7470.

¹³⁶ See SEC, 'Order Approving a Proposed Rule Change, Release No. 34-63311' (12 November 2010).

¹³⁷ See SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (18 July 2012) 27.

¹³⁸ For further details, see Appendix 4. See also SEC, 'FAQs to Large Trader Reporting' (2014) Question 1.1 <<http://www.sec.gov/divisions/marketreg/large-trader-faqs.htm> (<http://perma.cc/36TG-B6EA>)> accessed 25 June 2014.

¹³⁹ SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 137) 27.

¹⁴⁰ SIFMA, 'Short Sale Reporting Study' (23 June 2011) 3.

designated information including whether a transaction was a purchase, sale, or short sale ('electronic blue sheet' ('EBS') submissions). These requests are generated in connection with inquiries into questionable trading and help assist the SEC with investigations of federal securities violations including insider trading and market manipulation by identifying buyers and sellers of particular securities.¹⁴¹

Large Trader Rule

The SEC also now requires 'large traders'¹⁴² to identify themselves and obtain a large trader identification number from the SEC.¹⁴³ This number allows activities of large traders to be aggregated across multiple broker-dealers and provides the SEC with a faster way to acquire information about their activities, including short selling activity.¹⁴⁴ Upon request the SEC also requires broker-dealers to capture and report through the EBS, large trader transaction information including the time of execution for any trade involving a large trader. The large trader rule will not make any new data public.

5.3.1.3 The Consolidated Audit Trail

¹⁴¹ See SEC, 'Electronic Submission of Securities Transaction Information, Release No. 34-44494' (29 June 2001) that adopted rule 17a-25 under section 17 of the Exchange Act, codifying this requirement. The data comprises of trade executions, not orders or quotes, however the data does not include the time of execution.

¹⁴² For further details, see Appendix 4. See also SEC, 'Large Trader Reporting, Release 34-64976' (27 July 2011).

¹⁴³ Ibid. The rule requires large traders to have identified themselves to the SEC by 1 December 2011.

¹⁴⁴ SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 25.

All such reporting requirements provide mechanisms to capture information concerning short sale orders and trade reports and can also help assist the regulators in determining whether market participants are complying with the short sale requirements in Regulation SHO. Despite this however, such rules do not produce a complete audit trail and suffer from deficiencies including levels of accuracy, completeness and timeliness.¹⁴⁵ We have already observed that marking short sales can be fairly complex, and that there is a tendency to err on the side of marking orders short.¹⁴⁶ Likewise, the OATS information will not include order activity occurring at exchanges or broker-dealers that are not FINRA or Nasdaq members.¹⁴⁷

Further, an investigation by regulators concerning potential market manipulation involving short sellers could currently involve a rather cumbersome process including gathering data from the audit trails of various SROs, information requests via EBS reports, plus information from broker-dealers in relation to large trader activities.¹⁴⁸ Essentially, the existing regulatory data infrastructure is largely inadequate and ineffective to oversee widely dispersed trading across a variety of market centres.¹⁴⁹ Indeed, the SEC has stated that in performing oversight responsibilities, regulators have to ‘cobble together disparate data from a variety of

¹⁴⁵ SEC, ‘Consolidated Audit Trail, Release No. 34-67457 (Final Rule)’ (n 137) 27-28.

¹⁴⁶ SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 123) 21-22.

¹⁴⁷ SEC, ‘Consolidated Audit Trail, Release No. 34-67457 (Final Rule)’ (n 137) 28.

¹⁴⁸ SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 123) 29. Equity cleared reports may also be used that are generated on a daily basis showing the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member. This information is provided to the SEC on request.

¹⁴⁹ SEC, ‘Consolidated Audit Trail, Release No. 34-67457 (Final Rule)’ (n 137) 4.

existing information systems lacking in completeness, accuracy, accessibility and/or timeliness’.¹⁵⁰

With this in mind the SEC adopted rule 613 of Regulation NMS in July 2012 requiring SROs to submit a ‘NMS plan’ that will govern the creation, implementation, and maintenance of a consolidated audit trail (the ‘CAT’) for exchange listed securities and options.¹⁵¹ This sets in motion a multi-year project that will result in a comprehensive, data repository for all information concerning orders and execution.¹⁵² The plan was submitted to the SEC in September 2014 and is now subject to its review.¹⁵³ It is estimated that it could take between three to five years at the earliest before the CAT is implemented.¹⁵⁴ As we have already observed, the EU should follow the CAT’s development with interest: a pan-European reporting system would be more effective and efficient for overseeing trading and should also help improve the quality of data being received.

If the NMS plan is approved, it will enable the SEC and the SROs to have access to information on all orders to trade NMS securities.¹⁵⁵ This will include information on the symbol, security type, size, short sale order mark, customer

¹⁵⁰ Ibid 6.

¹⁵¹ Ibid 1. The CAT will also include information on modifications and cancellation of orders. For further discussion of CAT, see also section 5.3.4.2 below.

¹⁵² Securities Industry and Financial Markets Association and Davis Polk, ‘Current Market Structure Issues in the U.S. Equity and Options Markets’ (US Equity Market Structure Conference, 17 October 2013) 26.

¹⁵³ Note that an amendment and replacement of the plan was submitted to the SEC in February 2015.

¹⁵⁴ Note as well that in October 2014, FINRA announced its own initiative to implement a comprehensive automated risk data system initiative (‘CARDS’). This would require FINRA members to submit extensive data to FINRA on a monthly basis. Concerns have been raised as to duplication and whether this proposal is necessary on top of the CAT initiative, see e.g. Davis Polk, ‘FINRA Proposes New “CARDS” Data Collection System’ (30 October 2014).

¹⁵⁵ As observed, NMS securities broadly refer to exchange listed equity securities and standardised options.

identity, plus an open/close indicator.¹⁵⁶ Rule 613 also requires such information to be reported to the CAT's central repository by broker-dealers and exchanges no later than 8 am on the trading day following the day on which the information is recorded.¹⁵⁷ With this data, the SEC and the SROs should then be able to run processes when necessary to track short selling and buy to cover activity and quickly identify the activity of large short sellers.¹⁵⁸ Consequently, as we will explore further in the context of the Dodd-Frank proposals below, although the CAT also has some limitations, it should certainly help improve regulators' access to useful short selling data.

5.3.2 Emergency Reporting Rules

During the financial crisis, additional measures were enacted in relation to short selling reporting. On 18 September 2008 the SEC adopted an emergency order requiring institutional investment managers¹⁵⁹ to file short sale information with the SEC using 'Form SH' on a weekly basis. Reporting was required where managers exercised investment discretion¹⁶⁰ with respect to accounts holding 'section 13(f) securities'¹⁶¹ that had an aggregate fair market value of \$100,000,000 on the last

¹⁵⁶ This is likely to provide information on whether the transaction is to open or close a position with an order to buy that closes a position constituting a 'buy-to-cover', see SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 24.

¹⁵⁷ The initial proposal required real-time reporting. Other supplemental information will also be required the day following the day on which the information is received.

¹⁵⁸ See SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 24.

¹⁵⁹ For 'institutional investment manager' definition, see Appendix 4.

¹⁶⁰ 'Investment discretion' means that the manager has the power to determine which securities are bought and sold for the account(s) under management, or the manager makes the decision as to which securities are bought and sold even though someone else is responsible for the investment decisions, see section 3(a)(35) Exchange Act.

¹⁶¹ 'Section 13(f) securities' are defined in rule 13f-1(c) under the Exchange Act. This provides that they include securities of a class as described in section 13(d) of the Exchange Act that are admitted to

trading day of any month, and they had effected short sales of these securities.¹⁶² Broadly, the manager was required to report the number and value of securities sold short during each day, the opening and closing short position, the largest intraday short position, and the time of the largest intraday short position. Initially the order required that Form SH be filed electronically and made publicly available on the electronic data gathering, analysis and retrieval system ('EDGAR').¹⁶³ The order specifically stated that it would 'ensure transparency in short selling'.¹⁶⁴

However before the order took effect, it was amended to permit filings on a non-public basis. The SEC stated, in a footnote, that filings would be on a non-public basis 'in order to maintain fair and orderly markets and prevent substantial disruption to the securities markets'.¹⁶⁵ Given that the SEC's 18 September order had expressly sought to ensure transparency, this somewhat detracted from the original intention.¹⁶⁶ Further although the SEC went on to state that the forms would be made public two

trading on a national securities exchange or quoted on the automated quotation system of a registered securities association. In determining what classes of securities are section 13(f) securities, institutional investment managers may rely on the official list of section 13(f) securities published by the SEC, see SEC, 'Official List of Section 13(F) Securities Users' (2014) <<http://www.sec.gov/divisions/investment/13flists.htm> (<http://perma.cc/5HVQ-UNQP>)> accessed 4 June 2014.

¹⁶² The filing had to be made on the first business day of each calendar week following a week in which an investment manager had effected short sales of the specified securities, see in particular SEC, 'Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58591' (18 September 2008) 2-3. Options on section 13(f) securities and short sales of options on section 13(f) securities were not Form SH securities requiring reporting. However although options were excluded, certain transactions involving options were to be included. See further SEC, 'Guidance Concerning Disclosure of Short Selling' (2008) 3 <<http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm> (<http://perma.cc/D9FQ-RYX8>)> accessed 5 June 2014. There was also an exception for small short positions.

¹⁶³ SEC, 'Emergency Order Pursuant to Section 12(K)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Release No. 34-58591' (n 162) 3.

¹⁶⁴ Ibid 4.

¹⁶⁵ SEC, 'Amendment to Emergency Order, Release No. 34-58591A' (21 September 2008) 3; Erik R. Sirri, 'Regulatory Politics and Short Selling' (2010) 71 *University of Pittsburgh Law Review* 517, 530.

¹⁶⁶ Sirri (n 165) 530.

weeks after their due date, the order was amended again with the SEC stating that the forms would remain non-public to the extent permitted by law.¹⁶⁷ Essentially, the SEC reacted to criticisms it received regarding the risks about public disclosure, and it specifically highlighted concerns about an unintended increase in possible herding behaviour if public data was made available.¹⁶⁸ Although the U-turn may have been a little awkward for it, the decision to retain the data confidentially was sensible: it would avoid the risk that public disclosure could add to the disorderly spirals it was trying to prevent.

In October the SEC then adopted interim final temporary rule ('rule 10a-3T').¹⁶⁹ This extended the existing reporting requirements until 1 August 2009 with some modifications. Some of the details to be reported were eliminated, and the reporting deadline was extended.¹⁷⁰ Once again, the data would remain non-public.

It should be noted that in contrast to the disclosure rules that the FSA introduced during and following the financial crisis, the SEC's emergency provisions only covered direct short positions taken in the stock itself. Consequently, such reports would have been of limited assistance to the SEC: the disclosures would not necessarily reflect the true economic position of a short seller and may also have

¹⁶⁷ See SEC, 'Amendment and Extension to Emergency Order, Release No. 34-58724' (2 October 2008).

¹⁶⁸ Ibid 2.

¹⁶⁹ SEC, 'Disclosure of Short Sales and Short Positions, Release No. 34-58785 (Interim Final Temporary Rule)' (15 October 2008).

¹⁷⁰ Ibid 8-9. An exception was again also included for small short positions. The rule also required that short positions effected before 22 September 2008 be included (the emergency orders had not required disclosure of existing or outstanding short positions held before 22 September (the 'grandfather' exception). This had been mainly to address concerns relating to public disclosure of pre-existing short positions before the SEC indicated that filings would be on a non-public basis).

resulted in participants seeking to avoid disclosure through trading away from the equity markets.¹⁷¹

5.3.3 Public Disclosure since 1 August 2009

5.3.3.1 SROs and Transparency

Daily Publication: Aggregate Short Sale Volume

In July 2009 the SEC announced that instead of renewing rule 10a-3T it was now working with SROs to increase transparency and public availability of short selling related information. First, the SEC announced that SROs would commence daily publication on their own websites of aggregate ‘short sale volume’ information in each individual equity security for that day.¹⁷²

One-Month Delayed Basis: Individual Short Sale Transactions

Further, on a one month delayed basis, SROs would also publish information regarding individual short sale transactions (i.e. ‘trade-by-trade’ short selling transaction data) in all exchange-listed equity securities.¹⁷³ Informal guidance from

¹⁷¹ SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 123) 103. It is recognised that although beyond the scope of the thesis, this could be in part due to jurisdictional boundaries between the SEC and the Commodity Futures Trading Commission (‘CFTC’). Likewise, at this time pre-Dodd Frank legislation was in place that largely exempted the OTC derivatives market from regulatory oversight by either the SEC or the CFTC.

¹⁷² SEC, ‘Increasing Transparency around Short Sales’ (2009) 3 <<http://www.sec.gov/news/press/2009/2009-172.htm> (<http://perma.cc/5TNB-4NDG>)> accessed 2 June 2014. Short selling volume is defined as the volume of executed orders marked short (or short exempt following the introduction of the alternative uptick rule) pursuant to rule 200(g) of Regulation SHO, see SEC, ‘Short Sale Reporting Study, Release No. 34-64383 (Request for Comment)’ (3 May 2011) 3.

¹⁷³ SEC, ‘Increasing Transparency around Short Sales’ (n 172) 3. The SEC would also publish data twice monthly on FTDs for all equity securities regardless of the fail levels.

SEC staff indicated that individual investor identification or specification of an investor's holdings was not currently being contemplated.¹⁷⁴ Rather the delayed information was to be anonymised and would include data such as the transaction date and time, the stock symbol, the price, and the number of shares for every short sale transaction.¹⁷⁵

The aim was to provide greater information to investors through these initiatives, nevertheless this data can again overestimate the amount of transactions representing short sellers establishing or increasing a short position. This is because it is drawn in part from the order marks,¹⁷⁶ and we have already observed that these rules contain a restricted interpretation on when a person may mark an order long, plus the existence of SEC guidance that errs on marking orders short.¹⁷⁷ Further, such information will again only offer a partial picture as the initiatives only cover direct short positions taken in a stock.

FINRA Rule 4560: Public 'Total Short Interest' Reporting

In addition, FINRA also provides a type of aggregated short position reporting. Since 2007, FINRA member firms have been required to report the total shares in short positions¹⁷⁸ regardless of position size (the 'total short interest') that the firm holds in

¹⁷⁴ Schulte, Roth and Zabel, 'SEC to Increase Public Disclosure of Short-Selling' (29 July 2009).

¹⁷⁵ Note that the publication of such information on such a delayed basis would be unlikely to comply with IOSCO's principle that short selling should be subject to a reporting regime that provides timely information to the market.

¹⁷⁶ The information is also compiled using information obtained from FINRA's OATS. See SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 22.

¹⁷⁷ See *ibid* 22. See also SEC, 'FAQs on Regulation SHO' (n 129).

¹⁷⁸ Rule 4560(b) defines a 'short position' as that resulting from a short sale as defined in rule 200(a) of Regulation SHO. Note that FINRA rule 4560 considers only gross short positions in the stock itself.

all its customer and proprietary firm accounts in all equity securities twice a month through FINRA's web based regulatory filing system.¹⁷⁹ Again, this does not extend to short positions held indirectly through derivatives or otherwise. The total short interest data is published twice a month: the short interest data is released by exchanges listing the stocks and FINRA releases the short interest data in unlisted stocks.¹⁸⁰

Use of Data

Despite the increase in publicly available data, it appears that market participants, including issuers and investors, neither widely monitor nor use the volume or transaction data now available through the SROs.¹⁸¹ Indeed some issuers are not even aware of this information.¹⁸² This suggests that issuers and investors do not use such data to try and detect any abusive short selling: instead they rely on the SEC to monitor any potentially manipulative behaviour.¹⁸³ Further, the SEC still lacks direct access to the data necessary to quickly identify short sellers.¹⁸⁴

¹⁷⁹ SEC, 'Short Sale Reporting Study, Release No. 34-64383 (Request for Comment)' (n 172) 4. FINRA computes short interest using the information it receives from broker-dealers reflecting all trades cleared through clearing broker-dealers. See SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 17.

¹⁸⁰ FINRA rule 4560. See also SEC, 'Short Sale Reporting Study, Release No. 34-64383 (Request for Comment)' (n 172) 4; SIFMA (n 140) 4.

¹⁸¹ SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 19.

¹⁸² Ibid 49-50.

¹⁸³ Note that investors and issuers do appear to be aware of the bi-monthly short interest data published by FINRA and issuers have reported that they monitor this data from exchanges, rather than data vendors, to gauge investor sentiment, see *ibid* 17-18.

¹⁸⁴ *Ibid* 29. Separately, note that market participants can also obtain short selling data from the securities lending industry via a subscription. This can provide some indirect evidence of short selling but is not a perfect measure (for example securities lending may be used for purposes other than short selling and vendors selling the information do not have complete information), see *ibid* 33. One of the Dodd-Frank proposals also requires the SEC to promulgate rules to increase the transparency of information available to brokers, dealers, and investors with respect to securities lending. The SEC had

5.3.4 Dodd-Frank Proposals

5.3.4.1 Section 929X(a): Public Short Sale Disclosure

The analysis of the US rules so far has demonstrated that the rules stem from a variety of disparate sources that all contain a number of drawbacks and that this considerably adds to the challenges the SEC faces in performing its regulatory responsibilities.

With this in mind, the Dodd-Frank legislation granted the SEC broad authority to further regulate short sale transactions, and both section 929X(a) and section 417(a)(2) are relevant to short selling reporting requirements. First examining section 929X(a), this provides that section 13(f) of the Securities Exchange Act 1934 (the ‘Exchange Act’) is amended to require the SEC to prescribe rules providing for the public disclosure of the name of the issuer, the title, class, CUSIP number (i.e. a security’s identification number), the aggregate amount of the number of short sales of each security, and any additional information determined by the SEC following the end of the reporting period. At a minimum such public disclosure shall occur every month.¹⁸⁵

Section 13(f) applies to all institutional investment managers. Such managers are already subject to individualised public reporting requirements of relevant long positions on a quarterly basis,¹⁸⁶ and section 929X(a) envisages that such managers

until 21 July 2012 to announce such rules but at the time of writing the SEC had not yet taken any action in relation to this.

¹⁸⁵ Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, section 929X(a).

¹⁸⁶ Section 13(f) applies to institutional investment managers who exercise investment discretion over \$100 million in relation to section 13(f) securities on a quarterly basis (‘Form 13F’ reporting). For further details on section 13(f) securities, see footnote (n 161) above. Public reporting requirements are

will also publicly disclose certain short sale information on at least a monthly basis. Two schools of thought exist on whether section 929X(a) requires individualised or aggregate public disclosure, and as the SEC is yet to adopt rules with respect to section 929X(a), this is pertinent to the current discussion.

Proposal

Examining the section's legislative history, the version of the proposal ('section 7422') that was passed by the House of Representatives (the 'House'), provided that section 13(f) of the Exchange Act was to be amended and that institutional investment managers were to be required to report individual short sales to the SEC on a daily basis with a proviso that such information would be exempt from freedom of information requests.¹⁸⁷ The SEC would collect this private information, aggregate it and then publish the aggregate short sale information.¹⁸⁸

However the version passed by the Senate did not contain an analogous provision to section 7422.¹⁸⁹ The only provision in the Senate bill relevant to short selling was section 415 that called for a SEC study and report to Congress. This materialised into section 417(a)(2) of Dodd-Frank that will be discussed further below. During the House-Senate conference, the House proposed amending the

also triggered when a person acquires a significant threshold of over five per cent in a firm's equity securities (a 'Schedule 13D') report.

¹⁸⁷ House of Representatives, *Wall Street Reform and Consumer Protection Bill 2009, H.R 4173* (11 December 2009), section 7422 (H.R 4173 was also the House version of the bill that eventually became the Dodd-Frank Act).

¹⁸⁸ The proposal suggested a minimum of publication every three months, Managed Funds Association, 'Comments on Section 929X of the Dodd-Frank Act' (7 February 2011) 3-4.

¹⁸⁹ *Ibid* 4.

Senate bill by including section 7422, and the Senate accepted subject to the deletion of the paragraph requiring private daily reporting on a confidential basis.¹⁹⁰

It is disappointing that it was the provision requiring confidential reporting of individual short sale positions that was deleted. As we have already observed such a requirement could help increase the information available to the SEC with respect to net short positions and could in principle assist with the detection and punishment of abusive behaviour: one of the SEC's particular concerns.

Aggregate or Individual Public Disclosure?

In relation to the remaining wording, it has been suggested that because section 929X(a) amends section 13(f) of the Exchange Act, this indicates Congress's intent to require individualised public disclosure of short sales. This is because it will be an extension of existing section 13(f) provisions requiring individualised public disclosure of certain long positions.¹⁹¹ Indeed, given that SROs already publish reports containing aggregated short selling data, it could be queried why Congress would choose to enact an additional provision that merely reflects current practice.¹⁹² This is an interesting argument and certainly seems sensible to the extent that it would introduce symmetry into the approach taken in the US to long and short position disclosures (something we have observed to be inherently lacking in the EU) while avoiding overlap with existing public reports being produced and disseminated by the SROs.

¹⁹⁰ Ibid 4.

¹⁹¹ Ibid 4.

¹⁹² Ibid 4.

On the other hand, it is not necessarily unusual for Congress to choose to codify an existing practice to ensure it continues.¹⁹³ Likewise, although SROs publish certain aggregate information, there is not currently a publicly available ‘market-wide’ report that for example, covers all exchange and OTC transactions. Further, based on the evolution of section 929X(a) and its actual language that refers to the public disclosure of the ‘aggregate amount of the number of short sales’, such considerations arguably point to aggregate and not individual public disclosure of short sales. Indeed, given the serious concerns we have already observed with individual public disclosure, it would be preferable for this interpretation to be taken.¹⁹⁴ With this in mind, the general expectation seems to be that information will be submitted to the SEC who will then release it on an aggregate basis.¹⁹⁵ At the time of writing however the SEC had not adopted rules and there was no definitive timeframe specified. This suggests the issue is unlikely to be resolved imminently and this may remain in the long grass for the time being.

5.3.4.2 Section 417(a)(2): SEC Study and Report

Aside from section 929X, section 417(a)(2)(A) provided that the SEC should conduct a study of the feasibility, benefits, and costs of requiring reporting publicly, in real-time, short sale positions of publicly listed securities, or alternatively only reporting these to the SEC and FINRA. Section 417(a)(2)(B) also provided that the SEC

¹⁹³ Ibid 4.

¹⁹⁴ Although this would be subject to the cost implications associated with aggregation that we have already highlighted in section 5.2.1.1 above.

¹⁹⁵ See e.g. SIFMA (n 140) 3.

should conduct a study into the benefits and costs of conducting a voluntary pilot in which public companies agree to have all trades of their shares marked ‘short’, ‘market maker short’, ‘buy’, ‘buy to cover’ or ‘long’ and reported in real-time through the Consolidated Tape.

Section 417(a)(2) required the results to be submitted to Congress by 21 July 2011. The SEC did not meet this deadline but submitted its report in June 2014. As we will discuss, the SEC compared these options to a baseline that included both currently available data and data that would potentially be available from the proposed CAT. Ultimately, the SEC concluded that none of the alternatives proposed were likely to be cost effective when compared to this baseline.¹⁹⁶ As we will observe, this is to an extent a sensible conclusion when one takes into account the CAT’s development. However it is still at a very early stage and much may hinge on how this ultimately proceeds. Further, as the CAT will initially only cover exchange-listed securities and options, this will also reduce its benefits.¹⁹⁷

5.3.4.3 Section 417(a)(2)(A): Short Position Real-Time Reporting

Reporting that Identifies Short Sellers

Real-time public disclosure that identifies short sellers would provide market participants with new information on short selling positions within a trading day that

¹⁹⁶ SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 123) 114.

¹⁹⁷ SEC, ‘Consolidated Audit Trail, Release No. 34-67457 (Final Rule)’ (n 137) 82-3.

they cannot currently infer from existing information.¹⁹⁸ Likewise, including an investor's economic exposure to a stock would also provide a more accurate picture to regulators and the public.¹⁹⁹

Nevertheless, the drawbacks we observed at section 5.2.2.2 above in relation to the EU's public disclosure requirements remain prominent. We do not need to repeat these issues here but given, in particular the volume of information that would be released (for instance the SEC estimates there could be approximately 24 million short position changes each day), most market participants would be unable to directly and thoroughly analyse the data. There would also be considerable practical problems with real-time reporting: such a regime would require an entirely new infrastructure that could result in significant compliance costs. Further the on-going costs of compliance to short sellers and others could also be significant.²⁰⁰

Separately, real-time public reporting could also subject short sellers to issuer retaliation: for example issuers could bring lawsuits, take action through claims in the media, or apply pressure through business relationships that exist outside trading.²⁰¹ The information disseminated could enable issuers to improperly orchestrate a short squeeze,²⁰² and issuers could refuse to meet short sellers or refuse to extend to them

¹⁹⁸ SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 73.

¹⁹⁹ Ibid 103. The SEC used the term 'short position' to cover both an investor's direct position and its economic exposure to a stock through all relevant financial instruments.

²⁰⁰ Ibid (n 123) 86. Such reporting could also be subject to human errors.

²⁰¹ Ibid 82.

²⁰² For example issuers could coordinate illegally with existing shareholders to terminate and recall outstanding securities' loans. Unless a substitute lender could be found short sellers may be forced to close out positions before they were ready to do so, see *ibid* 82.

invitations to ‘investor days’ where they discuss their public disclosures with investors, creating an asymmetry between short sellers and long position holders.²⁰³

Indeed, with such issuer retaliation in mind, an interesting recent study by Lamont suggested that such issuer behaviour could harm price efficiency.²⁰⁴ Specifically issuers taking such actions tended to underperform in the twelve months subsequent to the anti-shortening action, with returns approximately 2.34 per cent a month lower than the market, suggesting overvaluation of their securities. These low returns were highly persistent, and continued for years.²⁰⁵ Notably as well, sometimes the issuers who took such retaliatory action were subsequently investigated and then subject to enforcement action themselves by the SEC.²⁰⁶

Turning to real-time reporting that would only identify short sellers to the regulators, such a regime would still entail the same costs of implementation and compliance as the public regime. Further, the SEC also considered that the benefits

²⁰³ Ibid 83.

²⁰⁴ See Owen A. Lamont, ‘Go Down Fighting: Short Sellers vs. Firms’ (2012) 2 *The Review of Asset Pricing Studies* 1, 15-16. Lamont examined 327 events from 266 different firms from March 1977-May 2002. To be included in the sample, firms had to mount some sort of defence against short sellers or accuse them of wrongdoing.

²⁰⁵ Note that an alternative explanation that insiders knew that a firm was overvalued so the low returns reflected inside information instead of short sale constraints did not explain why it took so long for the information to be reflected in the prices. As the low returns persisted for years, it was not primarily a short-term under-reaction to bad news. Equally, although short sellers could be manipulating the prices, many of the sample firms were subsequently revealed to have been fraudulent: thus short sellers were usually vindicated by subsequent events. See further *ibid*.

²⁰⁶ For example in 2002 Allied Capital Corporation (‘Allied’) lobbied the SEC to investigate David Einhorn (‘Einhorn’) and his hedge fund Greenlight Capital (‘Greenlight’) without specific evidence of wrongdoing. This followed a negative speech Einhorn gave about Allied describing why Greenlight had a short position in Allied. No enforcement action was taken against Einhorn or Greenlight but the SEC subsequently investigated Allied and filed a settlement enforcement action at the conclusion of its investigation. Likewise in 2010 when Spongetech Delivery Systems Inc. (‘Spongetech’) alleged a short sale attack, the SEC subsequently sued the company and two of the directors for multiple violations of securities laws. Two months later Spongetech filed for bankruptcy and the directors also pleaded guilty to criminal securities fraud charges. See further Charles F. Walker and Colin D. Forbes, ‘SEC Enforcement Actions and Issuer Litigation in the Context of a “Short Attack”’ (2013) 68 *Business Lawyer* 687.

would be modest if the CAT is implemented, as this would provide regulators with almost the same information albeit on a less timely basis.²⁰⁷

Aggregate and Anonymous Reporting

The final option of requiring reporting of aggregate, non-identified, public disclosure of short positions was described as a real-time version of the current short interest regime.²⁰⁸ However the benefits of this option were unlikely to be substantial and many of the limitations already highlighted would also remain. For example the data would be cumbersome to work with and there would be high compliance costs. Indeed, as we have already observed in relation to the EU, these costs could in fact be higher than with identified short position reporting due to the additional step of having to aggregate the data before disclosing it.

5.3.4.4 Section 417(a)(2)(B): Short Sale Transaction Data: Real-Time Reporting on the Consolidated Tape

Turning to the second study, this related to public companies agreeing to have all trades in their shares marked and reported in real-time through the Consolidated Tape. As we have already observed, the current sell order marks required are not reported to the Consolidated Tape: they are maintained as part of the broker-dealer and exchange records, and most are required to be submitted to FINRA.²⁰⁹

²⁰⁷ SEC, 'Short Sale Position and Transaction Reporting Report' (n 123) 109.

²⁰⁸ Ibid 93.

²⁰⁹ Ibid 34. Two of the marks required by the study, the 'market maker short' and 'buy to cover' are not existing order marks.

Real-time availability of transaction marks would undoubtedly permit even greater granular distinctions between the different types of buy and sell marks, increasing the comprehensiveness and precision of the data market participants would obtain.²¹⁰ It would also provide new information on real-time market sentiment and could discourage abusive short selling, especially if it enhanced real-time surveillance. However, as the transaction marks would reflect the investor's position at the time of the order entry rather than at execution this could result in over-estimations concerning the number of short trades taking place.²¹¹ Likewise, the benefits of this option would again only be modest once the CAT was taken into account. Indeed the only real benefit would be the real-time nature of the data. Further, although non-regulators such as issuers could use the data to monitor for aggressive behaviour, issuers have confirmed that they do not use, and in some cases are not even aware of, existing short selling volume and transaction data.²¹²

Next there would be the potential for mismarking, as well as mark misinterpretation that could result in poor trading decisions.²¹³ The sheer volume of the data would also limit any value to this option (for instance the SEC estimated there could be 23 million transaction reports per day initially) and it would be expensive to add the marks to the Consolidated Tape with hundreds of market

²¹⁰ Ibid 38.

²¹¹ Ibid 35. According to the SEC, the most feasible way to report transaction marks in real-time was to populate the transaction marks with information from the order marks.

²¹² Ibid 49-50.

²¹³ Ibid 44.

participants having to update relevant systems.²¹⁴ Ultimately, this option offered little additional regulatory benefit as this information is already broadly captured under existing requirements and is available to the SEC.²¹⁵ It would also provide regulators with little extra data once the CAT was implemented.

5.3.5 Comments

Short selling reporting requirements occupy only a small space in the US's regulatory landscape. Further, those reporting systems currently in place, at least prior to the CAT being implemented, are rather convoluted and complex. No current data regularly provides short sellers' identities to the regulator, and the available information may over-estimate those establishing or increasing a short position. Next, to the extent that public information is disclosed, this can be difficult to access and is also under-utilised.

Rather than the SEC re-introducing a type of price test plus circuit breaker as part of its armoury of restrictions in tackling potentially manipulative short selling, requiring confidential reporting of significant individual short positions may seem a preferable regulatory alternative. Although, as we have observed with the EU, it is not a perfect option, it would at least be a more 'market-friendly' approach using a discretionary system of regulatory intervention rather than an automatic intervention device.²¹⁶ In particular there would also not be the negative effects that price tests

²¹⁴ Ibid (n 123) 37. There were also concerns in relation to the voluntary nature of the pilot: for example some issuers would join if they believed it would benefit them, while those believing participation to be costly would not join. Moreover, pilots are also subject to various general limitations: for example market participants knowing a pilot is underway may not act as they would under a permanent regime. See *ibid* 64-65.

²¹⁵ NYSE Euronext, 'Testimony of Joseph Mecane' (Short Sale Roundtable, 30 September 2009) 2.

²¹⁶ Seraina N. Grunewald, Alexander F. Wagner and Rolf H. Weber, 'Short Selling Regulation after the Financial Crisis: First Principles Revisited' (2011) 7 *International Journal of Disclosure and*

produce that we observed in Chapter 4 and it would in theory provide a means to monitor and, if need be, regulate abusive market activity.²¹⁷ In this regard, it could perhaps be useful for the US to consider reinstating the deleted part of section 929X(a) in an amended form that also encompasses other related financial instruments.

Based on our analysis, the CAT's implementation will make considerable improvements and its development should be welcomed. However, the project is still in its infancy with many of the difficult decisions, including costs, being delegated to the SROs, so it remains to be seen what will actually materialise going forward. Further, by initially only covering exchange-listed securities and options, this will also impact on its utility.²¹⁸ Likewise, the CAT will overlap with some of the existing reporting requirements. This is worth bearing in mind: the current regime is already rather murky and it would be helpful for duplicative rules to be eliminated for clarity.

5.3.6 EU and US Requirements: Concluding Comments

There are a number of clear statements that can be articulated with respect to short selling reporting requirements. First, any such system should encompass both direct and indirect positions. It demonstrates a level of sophistication and avoids any easy circumvention of the rules by market participants. Next, confidential individual

Governance 108, 126. It is recognised that this runs counter to the more interventionist approach to short selling regulation that has developed since the crisis however.

²¹⁷ Again, this is particularly the case given the SEC's approach to enforcement more generally, see John Coffee (n 124) 264-5.

²¹⁸ Note however that within six months of its effectiveness, the SROs and FINRA are to provide the SEC with information about expanding the CAT to incorporate transactions in OTC equity and debt securities. See SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 137) 82, 86.

reporting obligations can theoretically be helpful to regulators with respect to monitoring market activity, although such rules may prove to be of limited use in practice. Further, imposing individual public disclosure rules is particularly harmful: such rules are a de facto constraint on short selling and can negatively impact on short selling's contribution to market efficiency. Finally, implementing a uniform set of rules is crucial: it avoids uncertainty, reduces operational costs for participants, and should ensure easy access to salient information for the regulator.

There is currently little consistency in the approach taken to reporting short sales on both sides of the Atlantic. In the US, reporting requirements perform only a minor role, and we have considered a multitude of variety of rules: some imposed by statute, others by SROs, some that are general requirements, others that relate specifically to short selling. We have also observed that the current framework in the US is ill-equipped to deal with widely dispersed trading at a range of market centres and makes it highly challenging for the regulator to effectively investigate cases of manipulation.²¹⁹

In contrast to the US rules, the new EU provisions derived directly from CESR's proposed model. Although this means the new rules benefited from this prior analysis, we have also observed that CESR based its regime on only limited empirical evidence and that the industry rightly felt uncomfortable about introducing a permanent reporting regime in the absence of a more rigorous impact assessment. Indeed it is clear that the new European rules go too far: the reporting provisions apply permanently, the thresholds for notification and disclosure are too low, and

²¹⁹ Ibid 4, 6.

there are considerable concerns attached to its public reporting requirements of individual short positions. In particular, the evidence suggests that short sellers are avoiding crossing the public disclosure threshold and are moving capital elsewhere, and this cannot have been the policymakers' aim. Likewise, the EU rules also suffer from an ironic lack of harmonisation. With this in mind, the EU should follow the CAT's progress: a centralised reporting system would be far more in keeping with the Regulation's vision of harmonised reporting rules.

5.4 Conclusion

This Chapter has demonstrated that we remain a long way from supranational harmonisation with respect to short selling reporting requirements in the two jurisdictions. Further, there is (once again) not even any consistency between the implementation of the reporting rules within the EU. As we observed in Chapter 4, harmonisation both within and between jurisdictions is vital in today's interconnected markets to prevent confusion and to avoid additional challenges and costs for participants. Further, in the absence of a uniform approach, the provisions will be ineffectual and susceptible to regulatory arbitrage.

Looking to the future, both jurisdictions could pay heed to CESR and IOSCO that noted that short selling reporting is a greenfield area and that regulators in many markets will have limited experience.²²⁰ With this in mind, the EU and the US should acknowledge they have not yet found the correct balance with their choice of transparency regimes and start to contemplate what changes may now be required.

²²⁰ See e.g. IOSCO (n 41) 14.

For instance, in the EU, changes could be made to at least ease the various operational issues that parties are currently facing in practice. Equally, the SEC could (once the CAT is in place) seek to remove the large trader reporting requirements that will become redundant once the CAT is introduced. Lessons can continue to be learned on both sides of the Atlantic to ensure that any reporting rules are helpful rather than a hindrance.

Moving now from reporting obligations to sovereign CDSs, Chapter 6 will provide an overview of sovereign CDSs and their uses, and will seek to place the concerns that have been raised about uncovered sovereign CDSs in context through a consideration of the relevant economic literature. It will then critically examine the requirements introduced in the Regulation that broadly prohibit uncovered sovereign CDSs. Chapter 6 broadly suggests that the Regulation's restrictions are a misconceived response to a non-existent problem.²²¹

²²¹ Alexandros Seretakis, 'Taming the Locusts? Embattled Hedge Funds in the EU' (2013) 10 NYU Journal of Law & Business 115, 146.

Chapter 6: Should ‘Naked’ Sovereign Credit Default Swaps be Restricted?

6.1 Introduction

Following the financial crisis, investors became increasingly concerned about the financial outlook of a number of countries, including several in the euro area.¹ During the European sovereign debt crisis, many accused speculators of using uncovered (or naked) sovereign CDSs to exacerbate the fiscal problems of many countries, including Greece, through raising the borrowing costs of governments. The sovereign debt crisis sparked the interest of regulators and the sovereign CDS provisions in the Regulation were predominantly due to the perception that naked sovereign CDS activity contributed to Europe’s sovereign debt problems and that the speculative use of sovereign CDSs could destabilise markets. The final rules were highly contested, and, as discussed in Chapter 3, were essentially a consequence of political pressures and agendas stemming from the European Parliament (the ‘Parliament’) and particular Member States.

Chapter 6 provides an overview of sovereign CDSs and their uses and seeks to place the concerns that have been raised about sovereign CDSs in context through a consideration of the relevant economic literature. It then examines the requirements introduced by the Regulation that effectively prohibit uncovered sovereign CDSs.²

¹ BIS, ‘Intraday Dynamics of Euro Area Sovereign CDS and Bonds’ (BIS Working Paper No 423, September 2013) 5.

² Note that for ease of reference, a table containing some pertinent terms in this Chapter is attached as Appendix 5 to the thesis.

Broadly speaking the new rules only permit entering into a sovereign CDS transaction where it does not lead to an uncovered position in a sovereign CDS. This then depends on whether the CDS constitutes a permitted hedge. Aside from ‘pure’ hedging against the risk of decline in the value of the sovereign debt, permissible hedging includes ‘proxy’ hedging (i.e. hedging risks of other assets whose value is correlated to the value of the sovereign debt). However, in this regard there are a complex set of requirements to be complied with including geographical constraints, correlation and proportionality tests. The Parliament was also forced to concede to a temporary opt-out from the restrictions where the ban is damaging the government debt market.

Although the regulator has demonstrated a level of sophistication in recognising that there is more than one way to carry out a short sale, the Chapter suggests that the Regulation’s restrictions are a ‘misconceived response to a non-existent problem’.³ There are many benefits to using sovereign CDSs and little to substantiate the accusations that developments in the sovereign CDS markets led to higher funding costs for sovereign issuers during the crisis.⁴ Indeed the rules that have been introduced in the Regulation not only prohibit uncovered positions but also restrict much legitimate hedging activity. More generally, the rules may also lead to a reduction in investor interest in the underlying bond markets in many countries and so

³ Alexandros Seretakis, ‘Taming the Locusts? Embattled Hedge Funds in the EU’ (2013) 10 NYU Journal of Law & Business 115, 146.

⁴ Indeed, notably a 2012 report on the CDS market by the International Organisation of Securities Commissions (‘IOSCO’) stated that there was no conclusive evidence on whether taking short positions on credit risk through naked sovereign CDSs was harmful for high-yield sovereign bonds, see IOSCO, ‘The Credit Default Swap Market Report’ (June 2012) 38.

may in fact come at the detriment of the sovereign issuers that the restrictions were seeking to protect.⁵

It should also be observed at the outset of this Chapter that as no such crisis materialised in the US, no such restrictions were introduced in the US and that this Chapter is therefore limited to a discussion of the European rules. Other related reforms to the CDS and the OTC derivatives market are also beyond the scope of the chapter and thesis.

6.2 Terminology: Overview of Credit Derivatives and CDSs

A credit derivative is a general term used to describe various swap and option contracts designed to assume or lay off credit risk on loans, debt securities or other assets, or in relation to a particular reference entity or country, in return for either swap payments or payment of premium.⁶ Credit risk arises from the possibility of default on a pre-agreed payment and the transfer of credit risk is achieved through the payment obligations of the seller of the swap (also referred to as the ‘protection seller’) that are triggered by specified events of default (‘credit events’) affecting defined assets (also known as ‘reference assets’) or defined entities (also known as ‘reference entities’) such as a government or corporate issuer.⁷

⁵ AIMA, *The European Sovereign CDS Market* (2011) 17.

⁶ Joanna Benjamin, *Financial Law* (Oxford University Press 2007) para 4.51.

⁷ Ibid para 4.51; Commission, ‘Task Force Report on Sovereign CDS’, 7 <<http://online.wsj.com/public/resources/documents/ReportonsovereignCDS12072010.pdf> (<http://perma.cc/6YFM-4ATV>)> accessed 20 August 2013.

Turning to CDSs, these instruments were conceived as OTC products, and are quoted in basis points⁸ per year. A CDS price indicates the cost per year to buy or sell exposure to the possibility of a default or restructuring.⁹ Under the terms of a CDS contract (that will be laid out in documentation using standard forms),¹⁰ the purchaser of the CDS (also known as the ‘protection buyer’) will be obliged to make specified fee payments (often referred to as the ‘insurance premium’ or ‘CDS spread’) on an annual basis to the protection seller. The level of protection is usually expressed in terms of a ‘notional’ amount that is being protected and the length of time for which the notional amount is being protected.¹¹

Specifically with respect to a sovereign CDS agreement, the seller will receive the premium in exchange for bearing the risk of capital losses if a pre-defined default event occurs (including the sovereign’s failure to pay interest or principal on an obligation) in relation to the referenced sovereign entity and a predefined notional amount.¹² Sovereign CDS contracts are usually denominated in a currency different from the main currency of the deliverable obligations as it is assumed that if faced with a credit event, the local currency will come under pressure.¹³ CDSs on euro area sovereigns tend to be denominated in US dollars.

⁸ For further details, see Appendix 5.

⁹ Commission (n 7) 8.

¹⁰ The standard forms are most often produced by the International Swaps and Derivatives Association (‘ISDA’).

¹¹ AIMA (n 5) 20.

¹² Ibid 20. Note that in March 2012, the restructuring of Greek sovereign debt triggered payments by protection sellers of approximately USD 2.89 billion. Although there were concerns that a large flow of payments to buyers of CDS protection could have had a material systemic impact on the financial system at large (this was particularly related to the possibly high concentration of the exposures on a few protection sellers), the impact of the credit event was remarkably low. See e.g. Helen Cunningham, ‘DTCC Helps Ensure ‘Uneventful’ Greek CDS Payout’ *DTCC* (1 May 2012); IOSCO (n 4) 15-18.

¹³ BIS (n 1) 5.

To put these terms in context, if one party wishes to purchase protection on the notional amount of USD one hundred million of debt issued by a sovereign for five years, and the agreed CDS rate is five per cent per year, the party will pay a yearly premium to the protection seller of USD five million. If a credit event occurs in the five years, the seller will give the buyer the difference between the referenced debt and the market value of the defaulted debt. For example, if, due to the credit event, the debt now has only a market value of only USD thirty million, the buyer will collect USD seventy million from the seller.¹⁴

Where an investor purchases a sovereign CDS without having some kind of exposure to the credit risk associated with the underlying bond (i.e. where the investor does not hold the debt instruments or have some exposure to the debt), this is described as having an uncovered or naked sovereign CDS.¹⁵

6.2.1 Uses of Sovereign CDSs

Owners of sovereign debt purchase sovereign CDSs as a direct hedging tool in order to protect them from loss arising from a default or other credit event affecting the value of the underlying sovereign debt.¹⁶ Sovereign CDSs can also be used for arbitrage opportunities (i.e. the risk-free exploitation of price differences in connected

¹⁴ Darrell Duffie, 'Is There a Case for Banning Short Speculation in Sovereign Bond Markets?' (Financial Stability Review, July 2010) 56. Settlement can also be either in cash or by physical settlement although CDS contracts are typically cash settled.

¹⁵ Commission (n 7) 7.

¹⁶ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (April 2013) 3.

markets) in government bond markets.¹⁷ Traders can try and exploit pricing differences between CDSs and the underlying debt obligations by taking offsetting positions between the two (known as ‘basis trading’).¹⁸

Naked sovereign CDSs are also often purchased as ‘proxy’ risk management tools in order to hedge risks of other assets, such as national banks or utility companies whose value is correlated to the value of the sovereign debt.¹⁹ For instance, if one invests in a national airline and wants to protect against the downside risk of a sovereign crisis affecting the airline, one could purchase a sovereign CDS without owning the underlying government debt.²⁰ Similarly sovereign CDSs are also often used as a proxy to hedge positions in analogous positions (e.g. in bank debt) for which a CDS may not be traded (or may be highly illiquid and therefore expensive).²¹ Such positions help fill a gap by allowing investors to hedge country or sector specific risks and also support projects that would not be financed otherwise.²² Although, as will be observed at section 6.5 below, the EU provisions aim to ensure that legitimate proxy hedging activity can still be classified as ‘covered’ positions, the many uncertainties introduced by the complex European rules mean such activity may simply become too cumbersome or costly to be worthwhile for market participants.

¹⁷ Ibid 3 and Annex 2; European Commission, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps SEC(2010) 1055 15.

¹⁸ IMF (n 16) 3 and Annex 2; Impact Assessment (n 17) 15. See Appendix 5 for further details. See also section 6.2.3 below.

¹⁹ IMF (n 16) 3.

²⁰ IMF, *IMF Staff Comments on Commission Consultation on Short Selling* (August 2010) 7.

²¹ FSA, HMT and Debt Management Office, *Joint FSA/HMT/Debt Management Office Response to the European Commission Public Consultation on Short Selling* (2010) 10.

²² Thomas del Marmol, ‘Short Selling: Need or Fear? Impact on Financial Markets and Implications for Regulation’ 2011, 58 <http://www.professionsfinancieres.com/docs/2012102306_174_vn_m_short-selling.-need-or-fear.pdf> accessed 20 June 2013.

Finally, purchasing a naked sovereign CDS can also be used to reflect a negative opinion about the credit outlook of the sovereign issuer of the underlying bonds.²³ It is economically equivalent to short selling the underlying bonds, and both naked CDS purchases and short selling bonds provide useful functions by increasing the liquidity of the underlying markets.²⁴ Further, in line with the benefits of short selling that we observed in Chapter 2, both naked CDS purchases and short selling help to keep prices from only reflecting the activity of only the most optimistic market participants.²⁵

Naked sovereign CDSs provide a relatively simple mechanism for taking a short position and reflecting a negative view of the evolving credit risk associated with a sovereign reference entity: they are a ‘highly visible bellwether of a country’s perceived credit risk’.²⁶ Although other mechanisms can also be used to express views on the credit risk associated with a sovereign issuer (including short selling the underlying bonds or using other derivatives), such instruments can also reflect other risk as well as credit risk.²⁷ In contrast, the CDS market is more standardised: for example sovereign CDSs on Greece all have the unique reference, which is the credit risk of Greece.²⁸ Equally, there is not the same required outlay to enter into a short

²³ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 3, 19.

²⁴ *Ibid* 19.

²⁵ *Ibid* 19.

²⁶ AIMA (n 5) 5. CDS prices provide useful information about the credit risk of an entity and the CDS price theoretically reflects the credit risk of the reference entity, see Marmol (n 22) 25.

²⁷ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 3. For instance there can be interest rate risk attached to bonds.

²⁸ Impact Assessment (n 17) 16.

position on the CDS market that there is with purchasing a bond.²⁹ Finally, in general terms, it can often be harder to short sell bonds than to purchase a naked CDS.³⁰ Indeed this is particularly the case in the corporate bond market where there the secondary market is often illiquid.³¹ In contrast however, the government bond markets are generally much more liquid than their corporate counterparts meaning the bond market may play a bigger role for sovereigns.³²

6.2.2 Size of the Sovereign CDS Market

Overview

Turning to then examine the size of the sovereign CDS market in more detail, this section will illustrate that the sovereign CDS market is only a relatively minor part of the overall CDS market, which is itself only a small part of the OTC derivatives market. Further, sovereign CDSs are only a small fraction of the total government debt outstanding.³³ These are helpful points to keep in mind when we then turn in section 6.2.3 to consider whether sovereign CDS prices are in fact capable of manipulating bond prices.

²⁹ Ibid 16.

³⁰ For instance one needs to be able to borrow a sufficient quantity of bonds and deep repurchase agreement ('repo') markets in which to borrow them, IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 19.

³¹ Virginie Coudert and Mathieu Gex, 'The Interactions between the Credit Default Swap and the Bond Markets in Financial Turmoil' (2013) 21 *Review of International Economics* 492, 493, 499-500. Corporate issuers may also have different bonds with varying maturities leading to high fragmentation of the secondary market. See Marmol (n 22) 24.

³² Coudert and Gex (n 31) 495. However the funding conditions and liquidity of the government bond market can vary from state to state.

³³ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 4.

There are two basic measures of the size of the CDS market: the gross notional amount and the net notional amount. The gross notional amount is the total of all transactions that have not yet matured, prior to taking into consideration offsetting transactions between pairs of counterparties. However this measure can be misleading as it can significantly overstate the size of the market.³⁴ For instance, market participants will commonly enter into offsetting transactions, and this will raise the number of outstanding transactions, resulting in an increase in the overall gross notional amounts.

Instead, the net notional amount takes into account all offsetting transactions between pairs of counterparties. For instance if an investor has bought protection on USD 10 million of sovereign debt and decides to reduce this position to USD 4 million, it will enter into a new offsetting CDS agreement to sell protection on USD 6 million of sovereign debt and the investor's net position will then be USD 4 million.³⁵ The net notional amount is the basis for calculating the net notional payment in the event of a credit event and represents the maximum amount that could change hands if the reference entity defaults.³⁶ This is a more realistic measure as an increase in net notional exposure indicates there is increased demand for credit risk protection.³⁷

BIS: Size of the CDS Market within the OTC Market

³⁴ Commission (n 7) 10.

³⁵ Duffie (14) 56.

³⁶ Commission (n 7) 10-11; AIMA (n 5) 13.

³⁷ AIMA (n 5) 14.

The Bank for International Settlements ('BIS') provides information on a semi-annual basis with respect to the OTC derivatives market.³⁸ This data helps provide a general overview of the size of the CDS, and sovereign CDS market, particularly in comparison with the overall OTC derivatives market. Nonetheless the data also suffers from limitations: it only provides aggregate market statistics, and is based on surveys rather than actual registered positions in the market.³⁹

Although in 2007, CDSs came close to surpassing foreign exchange derivatives as the second largest segment in the global OTC derivatives market, notional amounts of all CDSs have since declined steadily.⁴⁰ For instance, according to the BIS semi-annual survey, by the end of 2013 the global OTC derivatives market constituted approximately USD 710.2 trillion, and the gross notional amount outstanding of the total CDS market was approximately USD 21 trillion (approximately 3 per cent of the total OTC market), down from its peak of approximately USD 58 trillion at the end of 2007.⁴¹ CDSs constituted the third segment in the OTC derivatives market with interest rate derivatives accounting for

³⁸ BIS, 'OTC Derivatives Statistics at End-December 2013: Statistical Release' (Monetary and Economic Department, May 2014). Central banks and other authorities from 13 jurisdictions participate in this survey (Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, UK, and the US). The market share of dealers who participate in the survey varies but is almost 100% in the credit category, see *ibid* 10. Although BIS also conducted a triennial survey reflecting end-June 2013, BIS noted that dealers participating in the semi-annual survey accounted for almost all outstanding CDS contracts, see BIS, 'OTC Derivatives Statistics at End-June 2013: Statistical Release' (Monetary and Economic Department, November 2013) 3.

³⁹ Martin Oehmke and Adam Zawadowski, 'The Anatomy of the CDS Market' Working Paper, September 2014, 8 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2023108 (<http://perma.cc/BE5J-YDK3>)> accessed 10 October 2014. Hence it runs the related risk of double counting.

⁴⁰ Note that to an extent the overall reduction in the size of outstanding CDS positions since 2007 has been assisted by the industry technique of 'trade tear-ups' or 'portfolio compression'. For further details, see Appendix 5.

⁴¹ BIS, 'OTC Derivatives Statistics at End-December 2013: Statistical Release' (n 38) 7. This figure includes single and multi-name instruments. The decline in overall CDS activity over the years has also been due to a contraction in inter-dealer activity, see BIS, 'OTC Derivatives Statistics at End-June 2013: Statistical Release' (n 38) 5.

the majority of OTC derivatives, followed by foreign exchange derivatives. By sector, sovereign CDSs constituted only approximately USD 2.6 trillion of all CDSs at the end of 2013 in terms of gross notional amounts outstanding: approximately 12.53 per cent of the CDS market.⁴²

Depository Trust & Clearing Corporation ('DTCC') Data

The DTCC provides information on CDSs at the reference entity level.⁴³ According to the DTCC, their data captures approximately 95 per cent of globally traded CDSs making it the most accurate and comprehensive publicly available dataset for CDS positions and trading.⁴⁴

Since October 2008 the DTCC has provided weekly CDS position data, disclosing the aggregate gross notional as well as the aggregate net notional outstanding on a particular reference entity. At the end of 2008, the top ten outstanding net notional sovereign CDS positions included the following EU sovereigns: Italy, USD 18 billion; Spain, USD 14 billion, Germany USD 10 billion; and Greece, USD 7 billion.⁴⁵ In contrast, by the end of 2010, the sovereign CDS market had increased in size, for instance the top ten positions outstanding included Italy, USD 26 billion; France, USD 18 billion; Spain, USD 17 billion; Germany USD

⁴² Percentages calculated based on the information in the BIS Statistical Release (May 2014). Out of 2.6 trillion, approximately 2.5 trillion were single name sovereign CDSs.

⁴³ All major dealers register their standard CDS trades with the DTCC who enters these into a Trade Information Warehouse ('TIW').

⁴⁴ Martin Oehmke and Adam Zawadowski (n 39) 8.

⁴⁵ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 4. Figures drawn from DTCC data and IMF calculations.

15 billion; UK, USD 12 billion; Portugal, USD 8 billion; and Austria, USD 7 billion.⁴⁶

However, while the market has undoubtedly increased in importance since 2008, it is still small in terms of its relative size to the government debt market. For example, the International Monetary Fund ('IMF') calculated that there was approximately USD 50 trillion total government debt outstanding at the end of 2011.⁴⁷ In contrast there were only approximately USD 3 trillion sovereign CDSs outstanding at that time.⁴⁸ Similarly, a 2012 report on the CDS market by IOSCO observed that the size of the CDS market relative to public debt for euro area sovereigns had remained relatively stable since 2008, contrary to the perception that the debt crisis had increased the demand of CDSs for hedging purposes.⁴⁹ Indeed IOSCO also noted that the ratio of net notional to public debt had remained stable or actually decreased for countries more exposed to the crisis including Greece, Ireland and Portugal.⁵⁰

As we observed at the start of this section, this data helps to illustrate that the sovereign CDS market is only a small part of the overall CDS market, which itself is only a minor segment of the OTC derivatives market. Further, sovereign CDSs

⁴⁶ Greece was below the top ten outstanding positions at USD 6 billion. The prominence of Italy could have reflected dealers hedging counterparty risk associated with large uncollateralised OTC transactions with Italy. Likewise the increased amount of sovereign CDS activity referencing Germany and the UK reflected them serving as a safe haven trade or proxy hedge. Ibid 4-5.

⁴⁷ This was defined as an aggregate of the general government debt that had notional amounts outstanding in terms of sovereign CDSs.

⁴⁸ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 4; BIS, 'OTC Derivatives Statistics at End-June 2012: Statistical Release' (Monetary and Economic Department, June 2012), Table 7 (gross notional amount).

⁴⁹ IOSCO (n 4) 7-9.

⁵⁰ Ibid 9.

represent only a small fraction of the total government debt outstanding.⁵¹ It is useful to keep these points in mind as we now turn to consider whether sovereign CDS prices are capable of manipulating bond prices. Further and more generally, given the very small size of the sovereign CDS market, it is also relevant to ask whether this market should have been such a concern for regulators, particularly in comparison with other, much larger, derivatives markets.

6.3 Interaction between the Sovereign CDS and Bond Markets

6.3.1.1 Introduction

As we have already observed, during the sovereign debt crisis, politicians and regulators contended that the interaction between the bond and CDS markets could result in mispricing on the bond markets and lead to higher funding costs for governments.⁵² Essentially, when investors are concerned about a country's financial stability, they will demand higher returns (i.e. higher yields) on government bonds to compensate for the higher level of risk and this will increase a country's cost of borrowing.⁵³ Further, if the default probability on a bond increases, parties holding

⁵¹ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 4. Indeed, it is interesting to also compare the figures with earlier data produced by the Hedge Fund Standards Board ('HFSB'). The HFSB noted that at the end of 2009, CDSs constituted only 5 per cent of the overall OTC derivatives market (gross figures), sovereign CDSs constituted approximately only 11% of the overall CDS market (net figures) in April 2010, and that the sovereign CDS market was small in terms of relative size to government debt (sovereign CDSs were approximately 1 per cent of government debt) in May 2010, see HFSB, *HFSB Response to the European Commission Public Consultation on Short Selling* (2010) 8.

⁵² Impact Assessment (n 17) 24.

⁵³ Investors will start selling bonds to reduce exposure to government debt, pushing interest rates higher. Further if bond yields are higher, the interest rate costs for the country will be much greater and the government will have to spend a large proportion of tax revenues on interest payments making it difficult to reduce government debt (and it will also be difficult for a government to raise new money as it has to pay an interest rate that is acceptable to the market).

CDSs will profit from the increasing value of their position.⁵⁴ The common assertion of regulators and governments is that a rise in CDS prices will lead to a collapse in the underlying bond market prices, leading to higher funding costs for governments.⁵⁵

Consequently, during the crisis, regulators and governments became concerned about the incentives of CDS traders and that they could seek to speculate on a country's default.⁵⁶ Specifically, as we observed in Chapter 3, a letter from German Chancellor Merkel and French President Sarkozy to the Commission President in March 2010 demanded an inquiry into speculative practices in connection with CDS trading of government bonds. They stated that if such an inquiry demonstrated that there was a well founded suspicion that such speculative practices were having an impact on the development of bond yields, it should be examined whether such practices were suitable, and if necessary pass legislation.⁵⁷

With this in mind, it is worth pausing here to consider the interaction between the two markets and to also consider whether CDS prices are capable of manipulating bond prices. This is important, as for some, any evidence that CDS prices can sometimes lead price developments is then interpreted as indirectly demonstrating that CDS prices can manipulate bond prices and that restrictions should be introduced.⁵⁸

⁵⁴ Economic and Monetary Affairs Policy Department: European Parliament, 'Assessment of the Cumulative Impact of the Various Regulatory Initiatives on the European Banking Sector' (Brussels, August 2011) 20.

⁵⁵ AIMA (n 5) 14.

⁵⁶ Economic and Monetary Affairs Policy Department: European Parliament (n 54) 20.

⁵⁷ Stephen Fidler, 'What Sarkozy, Merkel Wrote on CDS' *The Wall Street Journal* (11 March 2010).

⁵⁸ AIMA (n 5) 7; IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 15. Broadly, the argument is that if CDS market movements cause movements in the underlying bond markets, this provides easy manipulation opportunities.

This section discusses the relevant economic literature and suggests that the sovereign CDS market contributes to credit market price discovery but that the market is not perfectly ‘efficient’ or necessarily more price informative than the bond markets with respect to credit risk.⁵⁹ Further, the findings that the CDS market sometimes incorporates information faster than the bond market is not evidence that there is anything the matter with the CDS market, and should also not be used as indirect evidence that CDS prices are capable of manipulating bond prices, driving up the cost of government funding.⁶⁰ Indeed the Commission’s own Task Force that was set up to examine the effects of CDS trading during the sovereign debt crisis concluded that there was no conclusive evidence that developments in the sovereign CDS markets had caused higher funding costs for Member States.⁶¹

6.3.1.2 Does One Market Lead the Other?

Overview

As already observed, CDSs relate to the credit risk of an issuer: the risk of default of the issuer on its obligations towards its creditors. Equally, a bond purchaser is also exposed to various risks, including the credit risk that the issuer of the bond may not

⁵⁹ Houman Shadab, ‘Guilty by Association? Regulating Credit Default Swaps’ (2010) 4 *Entrepreneurial Business Law Journal* 407, 458; IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 24.

⁶⁰ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 15. Rather, what policymakers can legitimately worry about is manipulative shorting behaviour (i.e. ‘bear raids’). With thanks to Professor Enriques for this comment.

⁶¹ Commission (n 7) 21-22.

return the bond's principal amount at maturity.⁶² More technically, economists explain the relationship as follows: if one takes the yield of a bond with a credit risk and subtracts the yield of a comparable bond that is free from credit risk, the credit risk spread component can be isolated.⁶³ The credit spread of a bond of a particular sovereign and the CDS spread (or premium) for that sovereign should be closely linked as they both measure credit risk compensation for the sovereign (this is described as the 'no arbitrage' relationship).⁶⁴ The academic literature suggests that in a perfect market without frictions, both markets should be equally efficient and should adjust simultaneously when there is new information on credit risk: price discovery should occur at the same time.⁶⁵

In practice however, due to various market imperfections,⁶⁶ the difference between the CDS spread and the bond spread (the basis) tends not to be zero in the short run and can at times become sizeable.⁶⁷ Such imperfections have led to researchers investigating, amongst other issues, which of the CDS and the bond market is the more informationally efficient (i.e. which market leads price movements

⁶² Impact Assessment (n 17) 14.

⁶³ BIS, 'Intraday Dynamics of Euro Area Sovereign CDS and Bonds' (n 1) 5-6. See also Darrell Duffie, 'Credit Swap Valuation' (1999) 55 *Financial Analysts Journal* 73. Note that most papers compare CDS spreads to bond spreads rather than bond yields. Bonds spreads are the difference between the bond yield and the 'interest rate swap' (i.e. the risk-free rate), although some papers use German bonds as the risk-free measure.

⁶⁴ BIS, 'Intraday Dynamics of Euro Area Sovereign CDS and Bonds' 5-6.

⁶⁵ Jorge A. Chan-Lau and Yoon Sook Kim, 'Equity Prices, Credit Default Swaps, and Bond Spreads in Emerging Markets' (IMF Working Paper, February 2004) 3-4.

⁶⁶ For instance there may be differences in the relative liquidity of the two markets (i.e. the number of participants in a given market); there may be costs attached to shorting bonds; tax effects; and other factors including counterparty risks.

⁶⁷ BIS, 'Intraday Dynamics of Euro Area Sovereign CDS and Bonds' 6. At some point however, arbitrage opportunities will become feasible enabling investors to profit from the non-zero basis, and it will tend to revert back to zero in the long run.

and reflects credit risk more efficiently).⁶⁸ There was already some existing consensus that the CDS market was more efficient than the bond market regarding price discovery for corporate reference entities.⁶⁹ Such findings were in line with the greater liquidity of the corporate CDS market compared with the secondary corporate bond market (which is often illiquid), making it more straightforward to buy a CDS than to trade the bond.⁷⁰ However the economic empirical findings have been much more mixed for sovereign entities.

Appendix 6 to the thesis summarises the main empirical work in this relatively young field of literature, and it is clear that the mixed findings in this area can, to an extent, be attributed to different methodological choices, including the use of different samples, time periods and data sources.⁷¹ Nevertheless, overall the literature (including crucially the report of the Commission's own Task Force) broadly illustrates that the changes in spreads in sovereign CDSs and bond markets are mainly contemporaneous and that each market is equally likely to lead the other.⁷²

⁶⁸ (I.e. the degree of investor participation in the market and hence the amount of information contained in the prices determined therein): Patrick Augustin, 'Sovereign Credit Default Swap Premia' (14 January 2014, forthcoming, *Journal of Investment Management*) 21.

⁶⁹ See e.g. Roberto Blanco, Simon Brennan and Ian W. Marsh, 'An Empirical Analysis of the Dynamic Relation between Investment-Grade Bonds and Credit Default Swaps' (2005) 60 *J Fin* 2255; Haibin Zhu, 'An Empirical Comparison of Credit Spreads between the Bond Market and the Credit Default Swap Market' (2006) 29 *Journal of Financial Services Research* 211. This means the CDS market leads the bond market and is responsible for price movements.

⁷⁰ Coudert and Gex (n 31) 499. Indeed IOSCO reported that globally, net CDS exposure to private entities was four times higher than to sovereign entities at the end of 2011, see IOSCO (n 4) 7. IOSCO did observe however that although current research clearly showed that CDSs led the price discovery process for private issuers, it was not clear the extent this depended on the fact that CDSs were more liquid than bonds, or rather on the fact that short positions were easier to take in the CDS market. IOSCO also observed that these were not necessarily alternative explanations, see *ibid* 36-38.

⁷¹ Augustin (n 68) 21; BIS, 'Intraday Dynamics of Euro Area Sovereign CDS and Bonds' (n 1) 4. For findings relating to emerging markets, see e.g. Chan-Lau and Kim (n 65); John Ammer and Fang Cai, 'Sovereign CDS and Bond Pricing Dynamics in Emerging Markets: Does the Cheapest-to-Deliver Option Matter?' (2011) 21 *Journal of International Financial Markets, Institutions and Money* 369.

⁷² Commission (n 7) 21-26; Seretakakis (n 3) 135. Seretakakis also notes that in cases where price changes in the CDS market did lead changes in the underlying bond market, the changes in CDS spreads were linked to fundamentals responding to country-specific events, see *ibid* 135.

Notably, some of the findings also illustrate the relevance of counterparty risk in impeding the role of CDSs in price discovery: a factor that is particularly relevant given the OTC nature of the CDS market. Counterparty risk will have a negative effect on CDS prices: specifically the ability of the CDS market to lead the price discovery process will be impaired when levels of counterparty risk are high due to the perception of a lower quality of protection being sold.⁷³ Consequently, proposals to push such sovereign CDSs into centralised clearing under related European legislative developments would help improve the role of sovereign CDSs in price formation by reducing counterparty credit risk.⁷⁴

6.3.1.3 Sovereign Debt Crisis: Main Empirical Findings

Among the most directly relevant findings to this Chapter's discussion is the report of the Commission's Task Force on Sovereign CDSs that was mandated to examine sovereign CDS activity during the sovereign debt crisis. The report found no evidence of obvious mispricing in either the CDS or the bond markets, and that CDS spreads for more troubled countries were cheap relative to the bond spreads implying that CDS spreads could hardly be considered to be causing the high bond yields in these countries.⁷⁵ This was also consistent with a sufficient supply of insurance being offered to troubled countries and that speculators were acting as insurance providers

⁷³ Oscar Arce, Sergio Mayordomo and Juan Ignacio Peña, 'Credit-Risk Valuation in the Sovereign CDS and Bonds Markets: Evidence from the Euro Area Crisis' (2013) 35 *Journal of International Money and Finance* 124, 127; Ariel Levy, 'The CDS Bond Basis Spread in Emerging Markets: Liquidity and Counterparty Risk Effects' (Working Paper, April 2009) 35. Levy's findings also suggested that changes in the relative liquidity in the two markets could explain why there was no consistent pattern of one market leading the other. See Appendix 6 to the thesis.

⁷⁴ See below at section 6.3.1.4 for problems with this proposal however.

⁷⁵ Commission (n 7) 21-22.

at such times. This could be considered beneficial as it allowed institutional investors to take on more debt and keep the yields for such countries lower than otherwise would be possible.⁷⁶ Next, the spreads in the two markets were mainly contemporaneous and the vast majority of countries showed no lead or lag behaviour. When not changing contemporaneously, either the CDS or bond market was equally likely to lead or lag the other and the report concluded that price discovery was equally likely to occur on the CDS or bond markets.⁷⁷

Likewise, an interesting recent 2013 paper by Arce et al. suggested that although CDS markets led price discovery in most euro areas in normal times, during periods of acute stress in the Eurozone, the bond market led the price discovery process. The authors also re-emphasised the importance of levels of counterparty risk in explaining some of the variation in the price discovery process. In particular, they observed that increased levels of counterparty risk impaired the ability of the CDS market to lead the price discovery process due to the perception of a lower quality of protection being sold.⁷⁸ Finally, recent research conducted by the IMF observed that sovereign CDSs tended to reveal information quicker during times of stress but not at other times, and that the informational value of CDSs had become more important but

⁷⁶ Ibid 22.

⁷⁷ Ibid 25. See also Alessandro Fontana and Martin Scheicher, 'An Analysis of Euro Area Sovereign CDS and Their Relation with Government Bonds' (ECB Working Paper, December 2010); Dominic O'Kane, 'The Link between Eurozone Sovereign Debt and CDS Prices' (Bankers, Markets & Investors, March-April 2012) (both detailed in Appendix 6) for similar findings.

⁷⁸ Arce, Mayordomo and Peña (n 73) 127. See further details in Appendix 6. See also Manthos D. Delis and Nikolaos Mylonidis, 'The Chicken or the Egg? A Note on the Dynamic Interrelation between Government Bond Spreads and Credit Default Swaps' (2011) 8 Finance Research Letters 163 (detailed in Appendix 6) that found that CDSs lost their leading role in the price discovery process during stressful conditions. See BIS, 'Intraday Dynamics of Euro Area Sovereign CDS and Bonds' (n 1); and Giorgia Palladini and Richard Portes, 'Sovereign CDS and Bond Pricing Dynamics in the Euro-Area' (NBER Working Paper, November 2011) (both detailed in Appendix 6) for findings that the CDS market leads the bond market for most countries in terms of price discovery.

varied widely over countries and over time.⁷⁹ Notably, the IMF concluded that overall the evidence did not support the need to ban purchases of naked CDS protection.⁸⁰

6.3.1.4 Comments

Broadly, the literature suggests that the informational value of sovereign CDSs has become more important as the market has matured, but that the market is not perfectly 'efficient' or necessarily more price informative than the bond markets with respect to credit risk.⁸¹ Indeed, in line with the Commission's own Task Force, it appears that the sovereign CDS market sometimes leads the bond market, the bond market sometimes leads the CDS market, and that price discovery is equally likely to occur in either market.⁸²

Related to these findings, given that counterparty risk can impede the ability of the CDS market to lead the price discovery process, moving sovereign CDSs through centralised clearing would reduce counterparty risk and help improve the contribution of sovereign CDSs to price discovery.⁸³ However (although this goes beyond the parameters of the thesis) it is recognised in this regard that is trickier to

⁷⁹ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* 10.

⁸⁰ Ibid 1; See also IMF, *Meeting New Challenges to Stability and Building a Safer System* (April 2010) 46-48 where the IMF cautioned against a ban on naked sovereign CDSs.

⁸¹ Shadab (n 59) 458; IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 10; Augustin (n 68) 24.

⁸² There may be good reasons why there are particular periods when one market leads the other, including which market has the higher liquidity on a given day, see Commission (n 7) 16; IOSCO (n 4) 36.

⁸³ Central clearing would enforce strong risk management standards, multilateral netting of positions and sharing of extreme losses, IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 17.

centrally clear sovereign CDSs than other derivatives. Specifically central counterparties ('CCPs') are reluctant to clear sovereign CDSs due to concerns about 'wrong-way' risks. Broadly, clearing participants are required to post collateral to cover losses, and as this would be in the same currency as that underlying the sovereign CDS contract, the distress of a sovereign could lead to a vicious cycle that would impair the value of the collateral while increasing the risk in the CDS contract.⁸⁴ Aside from this concern and on a more practical point, sovereigns are also currently exempt from the centralised clearing requirements introduced in the European Market Infrastructure Regulation ('EMIR').

Next, the findings that the CDS markets sometimes incorporate information faster than bond markets does not provide evidence that there is anything wrong with the CDS market and should also not be used as indirect evidence that CDS prices are capable of manipulating bond prices, driving up the cost of government funding.⁸⁵ Linked to this, an interesting qualitative paper by Duffie observed that in the case of financially weaker European sovereigns, as the aggregate net CDSs represented such an insufficient portion of the total debt outstanding, CDSs would not be able to manipulate and affect the underlying debt.⁸⁶

Duffie noted that setting aside the fact that it was very difficult to profit from manipulation, achieving a sizeable price impact (through aggressive purchases of naked CDSs) would require manipulators to take positions that were large relative to

⁸⁴ Ibid 17-8.

⁸⁵ Ibid 15.

⁸⁶ Duffie, 'Is There a Case for Banning Short Speculation in Sovereign Bond Markets?' (n 14) 57; Marmol (n 22) 59.

the underlying debt.⁸⁷ The author specifically analysed the case of Greece and observed that the aggregate of net CDS positions for Greece had remained well under three per cent of the total amount of Greek debt outstanding between October 2008 and July 2010.⁸⁸ He concluded that even if all the holders of CDSs on Greece were pure speculators, this would only have had a minor effect on bondholders.⁸⁹

Ultimately the sovereign CDS market contributes to credit market price discovery,⁹⁰ but there is no strong evidence conclusively linking sovereign CDS trading with instability in the bond markets.⁹¹ Indeed in line with Duffie's findings, given the tiny size of the sovereign CDS markets compared with the underlying bond markets, manipulation of the latter by the former would be very difficult to achieve.⁹²

6.4 Banning Naked Sovereign CDSs?

⁸⁷ Duffie, 'Is There a Case for Banning Short Speculation in Sovereign Bond Markets?' (n 14) 57. He also observed that manipulation through spreading false information would also be difficult to achieve, see *ibid* 57-8.

⁸⁸ *Ibid* 57. He further observed that in every week since the DTCC had started reporting market-wide CDS positions, the increase in aggregate protection bought against Greek sovereign debt was less than 0.18 per cent of the total Greek sovereign debt outstanding.

⁸⁹ See also René M. Stulz, 'Credit Default Swaps and the Credit Crisis' (2010) 24 *Journal of Economic Perspectives* 73, 83 who, in the context of the financial crisis argued that CDS trading did not of itself lead to an acceleration of the turbulence leading to the default of Lehman Brothers. Likewise, see Shadab (n 59) 458 who noted that concerns about market manipulation should be carefully balanced against the role played by CDSs in contributing to credit market price discovery.

⁹⁰ Shadab (n 59) 458.

⁹¹ Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 542; IOSCO (n 4) 1, 38.

⁹² Impact Assessment (n 17) 25. Further even if one believed that price discovery in the sovereign CDS market *was* in fact indirect evidence in favour of price speculation driving up public borrowing costs, the ambiguous empirical results should caution against making any drastic regulatory changes that could negatively effect the 'efficient information transmission in financial markets', Augustin (n 68) 29-30.

In March and April 2010 the German regulator BaFin, and the Chair of CESR, commented that there was no evidence of CDSs being used to speculate on government bonds.⁹³ Despite this, as we observed in Chapter 3, both Chancellor Merkel and President Sarkozy started to raise concerns as to the possible role played by CDSs in relation to the price of Greek government bonds. Subsequently, in May 2010 (and reportedly on the request of the German Finance Minister) concerns that naked sovereign CDSs were being used to ‘gamble’ on the health of sovereigns led to BaFin introducing a ban on naked sovereign CDSs on euro-area government bonds.⁹⁴ BaFin justified the ban on the basis of exceptional volatility in euro-area bonds and the danger that excessive price shifts could trigger significant disadvantages for financial markets and threaten the stability of the entire financial system.⁹⁵ Nevertheless as we discussed in Chapter 3, given the unilateral nature of the act, it was likely to have been politically driven, especially caused by pressure on Chancellor Merkel within her political party on the response to the Greek debt crisis. Indeed the feeling that Germany had acted to improve its own finances was compounded by its ability to simultaneously issue new debt at the cheapest rate since 1998 aided by the short squeeze created by the ban.⁹⁶ As Chapter 3 then further

⁹³ In April 2010, CESR Chair Eddy Wymeersch was quoted as saying that CESR had not seen clear signs of any speculation or abuse in these markets. See e.g. AFME, ISLA and ISDA, *AFME, ISLA and ISDA Joint Response to the European Commission’s Public Consultation on Short Selling* (9 July 2010) 13. Equally the German regulator BaFin came to a similar conclusion in March 2010. It clarified that based on its monitoring of the markets for government bonds and CDSs of selected countries within the euro-area, it had not found any evidence of CDSs being used to speculate against Greek government bonds, see BaFin Federal Financial Supervisory Authority, ‘BaFin Clarifies: So Far No Evidence of Massive Speculation against Greek Bonds’ *BaFin News Release* (8 March 2010).

⁹⁴ The ban also covered naked short sales on sovereign debt, and naked short sales of shares in particular banks and insurers. See Alan Crawford, ‘Germany to Temporarily Ban Naked Short Selling, Some Swaps of Euro Bonds’ *Bloomberg* (18 May 2010).

⁹⁵ Stacy-Marie Ishmael, ‘BaFin Statement on Germany’s Naked Short Selling Ban’ *FT Alphaville* (18 May 2010). Germany subsequently made the ban permanent in July 2010.

⁹⁶ Harry Wilson, ‘Markets Crash as German Short-Selling Ban Bites’ *The Telegraph* (19 May 2010). See also Chapter 3, section 3.4.1. Indeed it is likely that such a ban created more of a preference for ‘safe’ German bonds (a ‘flight to safety’), meaning lower funding costs for Germany compared with other countries.

illustrates, highly politicised and febrile negotiations then took place, the ultimate outcome of which was a European-wide permanent prohibition on naked sovereign CDSs in the Regulation.

Before we turn in section 6.5 to examine the precise rules that have been introduced, it is worth observing a 2012 paper by Pu and Zhang specifically analysed the global impact of the German ban on the sovereign CDS market and examined five-year sovereign CDS spreads over the period October 12 2000 to April 5 2011.⁹⁷ Pu and Zhang considered the time trend of CDS spreads, volatility, liquidity, and macroeconomic conditions across fifty-four countries, including the ‘PIIGS’ countries (Portugal, Ireland, Italy, Greece, and Spain).⁹⁸ In line with the majority of the short selling literature that we observed in Chapter 2, the authors found that CDS spreads continued to rise after the ban in the debt crisis region and that market liquidity was also impaired for the PIIGS countries.⁹⁹ However, in contrast to the effect of short sale bans on the equity market, the authors did observe that the ban helped reduce CDS volatility.¹⁰⁰

The authors also observed that sovereign CDS spreads were closely related to a country’s macroeconomic conditions: for instance the PIIGS countries, whose CDS spreads had increased considerably since early 2010, had slower economic growth,

⁹⁷ Xiaoling Pu and Jianing Zhang, ‘Sovereign CDS Spreads, Volatility, and Liquidity: Evidence from 2010 German Short Sale Ban’ (2012) 47 *Financial Review* 171 176-7.

⁹⁸ *Ibid* 172-176. The sample included the PIIGS countries, seven other Eurozone countries, fifteen non-Eurozone European countries, nine Asian countries, seven Middle-Eastern countries, eight South American countries, Australia, New Zealand, and South Africa.

⁹⁹ *Ibid* 173. The majority of the short selling literature observed in Chapter 2 reported that short selling bans usually lead to an increase in bid-ask spreads for banned stocks.

¹⁰⁰ *Ibid* 172-3. The authors noted that this could be due to shrinking speculation activities after the ban. Due to the ban, investors could be cautious as to using CDSs to express their view on the sovereign credit risk and might be forced to unwind their position.

lower reserves, and higher debt in gross domestic product ('GDP').¹⁰¹ Overall the authors found that where a sovereign entity could not improve its economic condition, banning speculation on naked CDSs or short bond positions was not capable of 'suppressing the rampantly rising sovereign yields'.¹⁰²

Impact of a Permanent Prohibition

More generally it is likely that introducing a permanent prohibition on naked CDSs would destroy the market.¹⁰³ For instance, if the CDS market consisted of only hedgers, these market participants would not find counterparties, as the market would have no liquidity.¹⁰⁴ Indeed, the presence in the market of those who previously purchased naked sovereign CDSs and were then able to take the other side and sell protection could also help mitigate volatility during crisis times.¹⁰⁵ Hence, the absence of such market participants could in fact lead to less rather than more stability.¹⁰⁶ Further, in a 2010 paper, Stulz observed that there was no evidence that removing naked purchases of CDSs would help the economy, 'any more than attempts to reduce stock short-sales did during the crisis'.¹⁰⁷

A 2010 paper by Duffie reiterated these points, noting that regulations restricting speculation in the CDS markets could have the unintended consequence of

¹⁰¹ Ibid 173.

¹⁰² Ibid 172.

¹⁰³ Stulz (n 89) 85.

¹⁰⁴ Ibid 85.

¹⁰⁵ AIMA (n 5) 15.

¹⁰⁶ Ibid 15.

¹⁰⁷ Stulz (n 89) 85.

reducing market liquidity and this would raise trading execution costs for other investors who were not speculating.¹⁰⁸ Imposing restrictions could in fact have the opposite effect to that which is intended and increase the borrowing costs for sovereign issuers.¹⁰⁹ Equally, by making the hedging of sovereign debt more challenging, this could also discourage the purchase of sovereign debt, which could also have knock on effects for interest rates and public deficits.¹¹⁰ Further, by attempting to ban traders with negative information or beliefs, economic problems could also be delayed by ‘closing the collective eyes of the market’.¹¹¹

Next, introducing a prohibition on naked sovereign CDSs would likely be ineffective. For instance as we discuss further in section 6.6 below, as there are substitute strategies that can be used, such a ban (particularly in the absence of supranational coverage) may only encourage market participants to engage in regulatory arbitrage and move their positions into other assets correlated with sovereign risk that could also involve less transparent instruments, or to offshore jurisdictions.¹¹² Indeed, spillover into over markets could come with the unintended consequence of reducing financial stability.¹¹³ With this in mind, if the intention of

¹⁰⁸ Duffie, ‘Is There a Case for Banning Short Speculation in Sovereign Bond Markets?’ (n 14) 58. He also noted that it would lower the quality of information provided by CDS rates regarding the credit quality of bond issuers.

¹⁰⁹ Ibid 58. For instance a ban on CDSs could actually add to the pressure on government bonds leading to increased bond selling, making it more expensive for governments to borrow or service their debt. See BBA, *European Consultation on Short Selling: A Response by the British Bankers’ Association* (July 2010) 13.

¹¹⁰ AFME, ISLA and ISDA (n 93) 20.

¹¹¹ David Mason, ‘The Senator Has No Clothes: Why a Ban on “Naked” Credit Default Swaps Is Ill-Advised and Impractical’ (The Heritage Foundation, May 2010) 2.

¹¹² AIMA (n 5) 13. Indeed the Commission observed that a ban could easily be circumvented by investors trading CDSs in non-EU countries and that there was very little the EU regulators could do about this. See Impact Assessment (n 17) 47; Oskari Juurikkala, ‘Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis’ (2012) 9 ECFR 307, 340.

¹¹³ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 21.

the regulators is to simply discourage all and any speculation against a sovereign issuer, then the net should in fact be cast much further than naked sovereign CDSs to also encompass all such instruments that allow taking positions on the credit risk of an issuer that benefit from the worsening of credit risk of a country.¹¹⁴

Ultimately it is clear that a ban on naked CDSs will not prevent markets reacting to adverse information, and in the case of sovereigns it would seem far more prudent to focus on tackling the underlying fiscal problems of a country rather than seeking to ban the symptoms of the problem.¹¹⁵

6.4.1.1 Burning Down Your Neighbour's House?

It is also relevant here to observe an analogy that particularly surfaced in the media during the sovereign debt crisis. This suggested that the purchase of a naked sovereign CDS was akin to buying insurance on your neighbour's house.¹¹⁶ It was argued that just as such a situation would give a policyholder an incentive to then burn down their neighbour's house, equally a purchaser of a naked sovereign CDS would prefer to then see the borrower default. This can also be described as creating a risk of 'moral hazard'. For instance if a market participant purchased a sovereign CDS without having a proportionate insurable interest in the underlying debt

¹¹⁴ Italian Treasury, *EC Public Consultation on Short Selling* (9 July 2010) 3-4. This would include for instance futures and options.

¹¹⁵ Deutsche Bank, *Deutsche Bank Research: Credit Default Swaps* (December 2009) 23; AIMA (n 5) 13.

¹¹⁶ See e.g. Wolfgang Münchau, 'Time to Outlaw Naked Credit Default Swaps' *Financial Times* (1 March 2010).

obligation or exposure to the underlying credit risk, the holder of the CDS could have a perverse incentive to precipitate a default and obtain the pay-out from the CDS.¹¹⁷

Although this is an interesting analogy, it starts to break down when one bears in mind that the buyer of the naked sovereign CDS is unlikely to be able to increase the chance, or in fact trigger, a borrower defaulting. This is particularly the case given that, as already observed, the sovereign CDS market only represents a tiny fraction of the underlying bond market.¹¹⁸ Indeed as Duffie observed, Greece had already borrowed far more than it could pay back before CDS rates rose significantly.¹¹⁹ Further, a greater moral hazard could also potentially arise if a CDS protection buyer was a lender who was hedging its large loan to a sovereign borrower using a sovereign CDS. Such a lender may no longer be as interested in monitoring the borrower's credit quality and could in fact have more of an incentive than a purchaser of a naked CDS to force the borrower to default: the 'empty creditor' problem.¹²⁰

Legal Recharacterisation as an Insurance Contract?

Separately however, it is also worth pausing here to consider the relationship between naked CDSs and contracts of insurance. Specifically it is clear that the economic effect of a naked CDS is similar to the effect of an insurance contract against the risk

¹¹⁷ Impact Assessment (n 17) 25.

¹¹⁸ Duffie, 'Is There a Case for Banning Short Speculation in Sovereign Bond Markets?' (n 14) 58.

¹¹⁹ Ibid 58.

¹²⁰ Ibid 58. See further Henry Hu and Bernard Black, 'Equity and Debt Decoupling and Empty Voting II: Importance and Extensions' (2008) 158 University of Pennsylvania Law Review 625. However it is also acknowledged that as assessment of sovereign creditworthiness largely rests on public information this may not be of such relevance as for corporate entities.

of default without an insurable interest. Consequently if such a CDS contract were to be also legally characterised as an insurance contract it would be void whereas if termed as a CDS (in the absence of a ban) it would be valid.¹²¹

This question of whether credit derivatives might be legally recharacterised as insurance contracts was widely debated in the 1990s and Robin Potts QC was instructed on behalf of the International Swaps and Derivatives Association ('ISDA') to provide an opinion in relation to these concerns. Broadly, he advised that although insurance contracts and credit derivatives were functionally similar, credit derivatives were legally distinct as the payment obligation was not conditional on the payee's loss and there was no requirement for an insurable interest.¹²² With this in mind he concluded that for regulatory purposes, entering them could not be characterised as insurance business.¹²³ The Potts Opinion was relied on by the whole industry as conclusive,¹²⁴ and it was subsequently observed that due to the huge growth of the credit derivatives market the point of no return had long passed: the consequences of a recharacterisation would be too far-reaching to be contemplated.¹²⁵ Further the correctness of the Potts Opinion was also subsequently assumed in European

¹²¹ Hence, the legal treatment will differ depending on the parties' legal characterisation of the contract.

¹²² Benjamin (n 6) paras 5.140-5.142.

¹²³ This also had significance as, if they were so characterised as insurance, financial institutions would require to be authorised to carry out insurance business and would not be authorised to carry out other non-insurance business, Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (Hart 2011) 204-5.

¹²⁴ Ibid 205. The view has been questioned however, see e.g. Marcus Smith, 'The Legal Nature of Credit Default Swaps' [2010] *Lloyds Maritime and Commercial Law Quarterly* 386 who observed that the two differences identified by Potts QC did not prevent a CDS being a contract of insurance.

¹²⁵ Benjamin (n 6) 5.143.

legislation where CDSs have been regulated as derivative rather than as insurance contracts.¹²⁶

More generally however it should also be noted that the fact CDSs resemble insurance is not sufficient to merit regulating them as such. First, many contracts contain an element of risk sharing or insurance but are not regulated as insurance contracts.¹²⁷ Next, the reason insurance regulation does not extend to all such contracts is due to the precise purpose of insurance regulation.¹²⁸ In particular, one of the main justifications for a separate insurance law relates to concerns about unsophisticated consumers who need protection from entering contracts they do not understand, and such an argument does not extend to CDSs where the average market participant is sophisticated and capable of bearing losses.¹²⁹ Finally, even if one sought to regulate CDSs that look like insurance, there would be considerable difficulty in accurately drawing the dividing lines and parties could simply contract round the lines and enter equivalent ‘synthetic’ and unregulated transactions that had the same economic effect.¹³⁰ Indeed, as we will observe below (and have also observed in earlier Chapters), this issue of regulatory arbitrage is now also of particular relevance with the new European rules.

¹²⁶ See e.g. Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, art 2(1)(c). Note however that the Regulation’s recitals provide that sovereign CDSs should be based on the insurable interest principle although it has been suggested that the choice of words reflects a policy intention rather than seeking to re-introduce questions about regulating CDSs as insurance contracts, see Slaughter and May, *The European Regulation on Short Selling and CDS* (July 2012) 4.

¹²⁷ M. Todd Henderson, ‘Credit Derivatives Are Not “Insurance”’ (2009) 16 Conn Ins LJ 1, 4-5. Henderson provides the example of a farmer who enters into a contract to allow him to sell his crop at a fixed price in the future (a ‘forward’ contract) and is insuring against an increase in the price of wheat yet this is not regulated as an insurance contract.

¹²⁸ *Ibid* 4-6.

¹²⁹ Gullifer and Payne (n 123) 208.

¹³⁰ Henderson (n 127) 33; Gullifer and Payne (n 123) 208.

Legal Recharacterisation as a Gaming Contract?

A related issue in this context is whether CDS contracts could be recharacterised as ‘gaming’ or ‘wagering’ contract as such contracts were historically unenforceable.¹³¹ However although this is an interesting question, it is unlikely that naked CDSs could be broadly so classified. First, the English case law has held that speculation must be the sole purpose of both parties to the contracts for the term to apply.¹³² With this in mind it would be very difficult to show that both parties to a CDS contract were intending purely to gamble. For instance many CDS purchasers would be using the contract as a hedge, whereas the sellers would be seeking to provide a service for a price to make a profit.¹³³ Further and more practically, this is no longer an open question as the Gambling Act 2005 now provides that ‘the fact that a contract relates to gambling shall not prevent its enforcement’.¹³⁴

6.5 EU Regulation: A Ban on Naked Sovereign CDSs

6.5.1 Articles 4 and 14

As we observed in Chapter 3, the CDS provisions were particularly contentious during the negotiations and the final rules are complex reflecting the Parliament’s

¹³¹ Benjamin (n 6) section 5.136. See for instance, section 18 of the Gaming Act 1845. If this were the case, there would be no naked CDSs although there would still be short selling.

¹³² See Hawkins J in *Carlill v Carbolic Smoke Ball Company* [1892] 2 QB 489, 491.

¹³³ Smith (n 124) 406.

¹³⁴ Section 335(1); Benjamin (n 6) 5.144.

desire to prohibit such behaviour, whilst also seeking to enable legitimate hedging. Turning to the precise restrictions, article 14 provides that a person may enter into sovereign CDS transactions only where the transaction does not lead to an uncovered position in a sovereign CDS as referred to in article 4.¹³⁵

Article 4 provides for two types of permitted hedging. First, hedging is permitted where the sovereign CDS serves to hedge against the risk of default of the issuer where the person has a long position in the sovereign debt of that issuer to which the sovereign CDS relates.¹³⁶ Secondly, proxy hedging is permitted where the sovereign CDS serves to hedge against the risk of the decline of the value of the sovereign debt where the person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets, or financial obligations, the value of which is correlated to the value of the sovereign debt.¹³⁷ As we have already observed, proxy hedging is crucial to hedging and risk management in the CDS market, however in many cases it may be difficult to clearly distinguish between legitimate and illegitimate hedging activities.¹³⁸ Consequently as we will discuss in section 6.5.2 below, the rules introduce a complex set of requirements that are difficult to meet with certainty in practice.

¹³⁵ Regulation 236/2012, art 14(1). The article 14 restrictions do not apply to market makers however, art 17(1). Further, to exclude retroactive effect, transactions resulting in an uncovered position in a sovereign CDS that were concluded before 25 March 2012 may be held to the maturity date of the CDS contract, see art 46(2).

¹³⁶ Ibid art 4(1)(a).

¹³⁷ Ibid art 4(1)(b).

¹³⁸ Commission Delegated Regulation (EU) 918/2012 supplementing Regulation No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps with Regard to Definitions, the Calculation of Net Short Positions, Covered Sovereign Credit Default Swaps, Notification Thresholds, Liquidity Thresholds for Suspending Restrictions, Significant Falls in the Value of Financial Instruments and Adverse Events [2012] OJ 274/1, recital 6.

6.5.2 Delegated Regulation 918/2012: Conditions

Geographical Scope

Although a wide range of exposures can be hedged,¹³⁹ the use of sovereign CDS to hedge cross-border risks is not generally permissible. ESMA stated that it was the intention of the co-legislators that the geographical scope of the rules should not be drawn too broadly,¹⁴⁰ and there are only very limited exceptions to this (provided the correlation test is also met).¹⁴¹

Correlation

Next, correlation is a key test to eligibility. The test is one of ‘simple correlation’¹⁴² and the Delegated Regulation sets out alternative quantitative or qualitative correlation tests.¹⁴³ ESMA’s earlier technical advice had proposed a purely qualitative

¹³⁹ See *ibid* art 17.

¹⁴⁰ ESMA, ‘Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263’ (April 2012) 39.

¹⁴¹ For instance where the sovereign CDS references the sovereign Member State of a parent company that gives credit support to a subsidiary in another Member State, a sovereign CDS position will not be considered uncovered where it is to hedge exposure to the subsidiary, Delegated Regulation 918/2012 art 15(1)(a).

¹⁴² ESMA (n 140) 39. Note that this contrasts with the degree of correlation prescribed in relation to calculating net short positions in sovereign debt, where the Regulation refers to a test of ‘high correlation’, see Regulation 236/2012, art 3(5). Likewise, the Regulation’s restrictions on uncovered short sales in sovereign debt do not apply if the transaction serves to hedge a long position in debt instruments on an issuer, the pricing of which has a ‘high correlation’ with the pricing of the sovereign debt see *ibid* art 13(2).

¹⁴³ Delegated Regulation 918/2012, art 18(1). Some self-evident cases where the correlation test is deemed to have been met are set out in *ibid*, art 18(2) such as where the exposure being hedged relates to an enterprise that is owned by the sovereign issuer.

approach however the Commission chose to include both tests, observing that this was in line with the only EU precedent: the unilateral German ban.¹⁴⁴

The quantitative correlation test is met by showing a ‘Pearson’s correlation coefficient’ of at least 70 per cent between the price of the assets or liabilities and the price of the sovereign debt calculated on a historical basis using data for at least a period of twelve months of trading days immediately preceding the date the sovereign CDS position was taken out.¹⁴⁵ The qualitative correlation test provides that the test shall be met by showing ‘meaningful’ correlation: this is a correlation based on ‘appropriate’ data and is not evidence of a ‘merely temporary dependence’.¹⁴⁶

Article 19: Proportionality

Finally, the size of the sovereign CDS position must be proportionate to the size of the exposure that is being hedged. As matching assets and liabilities to create a perfect hedge is in practice difficult due to the diverse characteristics of different assets and liabilities as well as the volatility in their values, an exact match is not required.¹⁴⁷ If the exposure being hedged is liquidated or redeemed, it must either be replaced by equivalent exposures, or the CDS position must be reduced or otherwise disposed of.¹⁴⁸

¹⁴⁴ ESMA (n 140) 39; European Commission, Impact Assessment Accompanying the Proposal for Delegated Regulation 918/2012 SWD(2012) 198, 28.

¹⁴⁵ Delegated Regulation 918/2012, art 18(1)(a). For further details on Pearson’s correlation coefficient, see Appendix 5.

¹⁴⁶ Ibid art 18(1)(b). The time frame for the calculation is set out (broadly using the historical basis of the previous twelve months but an alternative time frame can be used).

¹⁴⁷ Ibid art 19(1). Limited over-provision is permitted in accordance with article 19(2).

¹⁴⁸ Ibid art 19(3). Article 20 also provides for the method of calculation of an uncovered CDS position. The calculation of a person’s position shall be of the net sovereign CDS position (i.e. any sales of the

Opt-Out

Finally, as observed in Chapter 3, the Parliament was forced to concede to an ‘opt-out’ provision if the CDS ban was damaging the government debt market. Hence, a relevant NCA may temporarily suspend the restrictions where it has objective grounds for believing its debt market is not functioning properly and that such restrictions may have a negative impact on the sovereign CDS market, especially by increasing the cost of borrowing for sovereign issuers or affecting the ability to issue new debt.¹⁴⁹ Such grounds include high or rising interest rates on the sovereign debt; and a widening of sovereign CDS spreads compared with other issuers.¹⁵⁰

Before suspending any restrictions, the authority must notify ESMA and the other NCAs (and ESMA shall issue an opinion within twenty-four hours but has no veto option).¹⁵¹ A suspension is valid for an initial twelve-month period and can be renewed for six-month periods.¹⁵² Where a NCA suspends restrictions, notifications of uncovered positions will then be required on reaching or falling below relevant

relevant sovereign CDS shall be deducted from the purchased CDS). When calculating the value of eligible assets or liabilities hedged or to be hedged by the CDS, a distinction is also made between static and dynamic hedging strategies (for further details, see Appendix 5). The value of the eligible portfolio of assets or liabilities is then deducted from the value of the net CDS position and if the resulting number is positive (i.e. the CDS position exceeds the value of the portfolio of exposures to be hedged), the position shall be considered uncovered. See further ESMA (n 140) 43-44; Credit Suisse, ‘The Regulation on Short Selling and Certain Aspects of CDS’ (Fixed Income Research, October 2012), Appendix.

¹⁴⁹ Regulation 236/2012, art 14(2). Note that the relevant competent authority in relation to sovereign debt of a Member State is defined in article 2(1)(j)(i) as the competent authority of that Member State to which the CDS relates, see also Juurikkala (n 112) 334.

¹⁵⁰ Regulation 236/2012 art 14(2)(a)-(e).

¹⁵¹ *Ibid* art 14(2). Separately, note that in exceptional circumstances competent authorities can also restrict the ability to enter into covered sovereign CDS positions, see *ibid* art 21.

¹⁵² *Ibid* art 14(2).

thresholds.¹⁵³ Separately, although ESMA has been granted broad powers with respect to other financial instruments in emergency situations, sovereign debt is expressly excluded. In such scenarios ESMA has very limited powers, including for instance the right to be fully informed of relevant developments.¹⁵⁴

6.6 Comments

Regulatory intervention brings significant risks with it and it is all the more concerning when there is little indication that sovereign CDS activity raises sovereign funding costs.¹⁵⁵ Indeed we have observed that there are many benefits to using sovereign CDSs, yet little to substantiate the allegations aired by governments and regulators during the sovereign debt crisis. With this in mind the resulting EU rules are clearly a ‘misconceived response to a non-existent problem’.¹⁵⁶

Turning to the precise nuts and bolts, it is clear that the Regulation tries to ensure that hedging and legitimate proxy hedging will still be permissible. Nonetheless, although it is not straightforward to establish a clear boundary between legitimate and illegitimate proxy hedging activities,¹⁵⁷ the complex set of requirements that have been introduced are very tricky to meet with certainty in practice.¹⁵⁸ For instance, the requirement that the quantitative correlation between the assets or liabilities and the price of the sovereign debt be calculated on a historical

¹⁵³ Ibid art 8.

¹⁵⁴ Ibid art 29; Juurikkala (n 112) 335-6.

¹⁵⁵ Moloney (n 91) 542; IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 2.

¹⁵⁶ Seretakis (n 3) 146.

¹⁵⁷ Moloney (n 91) 559.

¹⁵⁸ AFME and ISDA, *ESMA Call for Evidence* (15 March 2013) 12.

basis does not take into account the fact that past correlation may change over time or may not yet exist in relation to situations of legitimate hedging of future risks.¹⁵⁹

Equally, it is also unclear what will satisfy the qualitative correlation test that refers to ‘meaningful’ correlation, based on ‘appropriate’ data, and is not evidence of a ‘merely temporary dependence’. Although this additional test has likely been included so that market participants can capture a broader range of correlated assets, relying on this test could be risky in practice.¹⁶⁰ For instance, where a market participant is called on to justify that the qualitative test has been met, a party could breach the prohibition if they cannot then demonstrate to the regulator that the data relied on was appropriate.¹⁶¹ Hence, due to the uncertainties as to whether either correlation test will be satisfied, sovereign CDSs will not be used to hedge exposures and this will also lead to a shift to other instruments.¹⁶²

6.6.1.1 Rules in Practice

These concerns have also been borne out in practice: specifically from August 2011 onwards, volumes of net notional European CDSs started to sharply decline, and this

¹⁵⁹ Ibid 36. For example in general it will not be possible to use sovereign CDSs to hedge ‘tail risk’ events, see further Appendix 5. See also Managed Funds Association, *Response to Consultation on Draft Technical Standards on Possible Delegated Acts* (March 2012) 15. Further, the adoption of a historic test is linked to an assumption that the past is the only guide to the future and in other areas of financial markets this is held to be unreliable (for instance, the phrase ‘past performance is not a guide to future performance’ is often used in the context of providing financial services to retail clients), see further AFME and ISDA (n 158) 36.

¹⁶⁰ Credit Suisse (n 148) 8.

¹⁶¹ Travers Smith, *Short Selling: Remember, Remember the First of November* (26 October 2012) 3. Separately however it should also be observed that the Regulation does not specify penalties for infringement and only requires that these be established by the Member States. This means penalties may vary widely between countries and that the rules could ultimately be an ineffective deterrent. See Regulation 236/2012, art 41; Juurikkala (n 112) 340.

¹⁶² AFME and ISDA (n 158) 11.

could have been in part due to short positions being unwound in advance of the Regulation's introduction.¹⁶³ In fact, some market participants indicated that positions were being unwound as it was feared that the hedging rules were 'so vague' that they could be viewed as speculating even if they were not.¹⁶⁴ Market participants also observed anecdotally that Asian participation in the European bond markets had fallen to under fifty per cent since the Regulation's introduction, suggesting that the restrictions could be driving investors away.¹⁶⁵

There has also been a sharp decline in the volumes traded on the European sovereign CDS indices, resulting in significantly reduced liquidity. Broadly speaking, CDS contracts on a basket of reference entities are known as 'so called index and tranche' CDSs.¹⁶⁶ Such indices comprise of many reference entities with a theme in common (e.g. European sovereigns). The index is composed of the fifteen constituents with the largest sum of weekly trading activity and entities are weighted equally in the index.¹⁶⁷ Every six months, a new 'series' of the index is introduced, updating the set of constituents in the index. Since the Regulation came into force volumes traded on the main European sovereign CDS index, the Markit iTraxx SovX Western Europe Index (the 'SovX' index), have declined one hundred per cent (i.e. it has essentially been shut-down).¹⁶⁸ Markit, (the index provider) also announced that

¹⁶³ ESMA, 'Technical Advice on the Evaluation of Regulation (EU) 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (June 2013) 90; IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 17. The IMF noted that Italy was the exception to this and that this could be due to Italy having substantial uncollateralised positions with a number of banks that were using sovereign CDSs to hedge the counterparty risk on these contracts.

¹⁶⁴ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 17.

¹⁶⁵ AFME and ISDA (n 158) 11.

¹⁶⁶ IOSCO (n 4) 12.

¹⁶⁷ Markit, 'Markit iTraxx Sovx: A Global Sovereign CDS Index Family' (September 2014) 3-4.

¹⁶⁸ Deutsche Bank, *ESMA Call for Evidence* (15 March 2013) 9.

until further notice, no new series of the index would be published.¹⁶⁹ This has also resulted in the creation of a new sub-index for SovX known as ‘ex-EU’: constituents that do not form part of the European Economic Area.¹⁷⁰ Again, this only serves to further demonstrate that the Regulation’s constraints have negatively impacted the use of sovereign CDS indices, including for responsible risk management.¹⁷¹

Regulatory Arbitrage

On a related point, ESMA’s evaluation of the Regulation, (the ‘Evaluation’) has also demonstrated that, given the rules on hedging, this has led to a predictable shift to other asset classes. For instance open interest in futures contracts has increased (especially on French and Italian bonds).¹⁷² Broadly speaking such regulatory arbitrage (that we have also observed in relation to other aspects of the Regulation in earlier Chapters) will always occur when regulation covers only one aspect of a market: market participants will seek to avoid the additional costs of regulation and redirect their market activity to the unregulated market: the ‘boundary problem’.¹⁷³ In the context of sovereign CDSs this poses a problem for regulators since there are ‘literally an infinite number of potential contracts and contract forms that can be used by investors to share and transfer credit risk’.¹⁷⁴ Indeed aside from the observed shifts to government future contracts, participants could also choose to short the underlying

¹⁶⁹ Markit (n 167) 4.

¹⁷⁰ Deutsche Bank, *ESMA Call for Evidence* (n 168) 9.

¹⁷¹ ESMA (n 163) 27-8.

¹⁷² *Ibid* 94.

¹⁷³ Markus Brunnermeier and others, ‘The Fundamental Principles of Financial Regulation’ (Geneva Reports on the World Economy, 2009), Appendix; Henderson (n 127) 33.

¹⁷⁴ Henderson (n 127) 33.

bonds, use corporate CDSs¹⁷⁵ as a proxy for a sovereign CDS, and also utilise more opaque and customised OTC derivatives contracts. With this in mind there are also clear regulatory inconsistencies (that enhance the regulatory arbitrage issue) through regulators choosing to treat sovereign CDSs differently to corporate CDSs. Ultimately it is suggested that regulators should not hold too much confidence in the European restrictions proscribing the area of contracting in the marketplace.¹⁷⁶

Ambiguous Drafting

Linked to this point, there are arguably also avenues for market participants to ‘work the rules’ to their advantage over time, even if initial indications have suggested that parties are currently anxious of falling foul of the provisions. Considering for instance article 14(1)(a) of the Delegated Regulation (this article broadly enables proxy hedging where assets are correlated with the risk of the decline in the value of the sovereign debt), a fund that holds bonds in bank A that is established in jurisdiction X should be able to hedge their position with a sovereign CDS on sovereign X provided it satisfies the correlation rules. In such a case it should be relatively straightforward for market participants to objectively apply the quantitative 70 per cent test with legal certainty *ex ante*.¹⁷⁷

¹⁷⁵ Indeed it has also been argued that the corporate CDS market faces the stronger theoretical rationale for regulation than the sovereign market, see Juurikkala (n 112) 331.

¹⁷⁶ With thanks to Professors Armour and Enriques for their comments in this regard.

¹⁷⁷ Delegated Regulation 918/2012, art 14(1)(a); Commission, Impact Assessment Accompanying the Proposal for Commission Delegated Regulation 918/2012 SWD(2012) 198 (n 144) 27; Ashurt, *The "Naked" in Naked CDS Clarified?* (2012) Appendix. Specifically it offers a safe harbour to parties who know clearly in advance what is the level of correlation that assets and liabilities need to meet in order to be sure to be deemed covered by the sovereign CDS in conformity with the rules, Delegated Regulation Impact Assessment (n 144) 27.

The Commission noted that the 70 per cent threshold had been chosen because it was from this point onwards that the aligned volatility between the hedged assets and the sovereign debt was more correlated than not,¹⁷⁸ and it is certainly evident that this threshold offers participants more scope than the restrictions and reporting requirements in relation to sovereign debt that require a ‘high correlation’ equating to 80 per cent.¹⁷⁹ Further, ambiguities in the drafting of the rules could help provide parties with additional flexibility: for instance the wording in article 14(1)(a) provides that the assets or liabilities only have to ‘refer’ to public or private sector ‘entities’, and it is suggested that ‘refer’ is a broad term and that it is also unclear from the wording whether the reference to ‘entities’ is limited to only ‘legal entities’.¹⁸⁰ Consequently these (and other such) ambiguities in the rules could grant commercial participants more room to manoeuvre around the restrictions going forward.

Further, and linked to arguments already explored in Chapter 4 with respect to the short selling restrictions, in order to curtail the negative effect of the restrictions, market participants could also argue in favour of a narrow interpretation of the restrictions wherever there are any ambiguities in the drafting.¹⁸¹ This should help ensure that, in situations of uncertainty, the interpretation most favourable to the short seller prevails. This could be particularly helpful for example with regard to the qualitative test for correlation in relation to nebulous concepts such as a ‘meaningful’ correlation and ‘appropriate’ data. Finally, and more generally, as we will also

¹⁷⁸ Delegated Regulation Impact Assessment (n 144) 27.

¹⁷⁹ Delegated Regulation 918/2012, art 8(5). With respect to the sovereign debt restrictions, the percentage is not directly stated but the Commission has suggested 80 per cent in this regard, see Commission, ‘Short Selling: Technical Standards – Frequently Asked Questions’ (2012) 3.

¹⁸⁰ Ashurt (n 177) Appendix.

¹⁸¹ See Chapter 4.2.2 where arguments are also highlighted with respect to seeking to invalidate the bans.

observe in our concluding Chapter, there may be some potential with the passage of time to seek to water down some of the administrative rules.¹⁸²

Geographical Constraints

Next, the geographical constraints restricting much cross-border hedging are also problematic. Such constraints limit responsible risk management, as there may be several legitimate reasons for hedging a risk in one Member State with a sovereign CDS related to a reference entity in another Member State.¹⁸³ For example a market participant may have sovereign debt exposure to Germany but want to buy sovereign CDS protection on Denmark, as the Danish sovereign CDS is highly correlated but also is a cheaper proxy for German debt.¹⁸⁴ Separately, the geographical constraints also preclude the use of European sovereign CDS indices for general EU risks that do not include all Member States or pan-euro Member States in the index.¹⁸⁵

Indeed, it is likely that such geographical restrictions contradict core principles of the EU's single market: for instance even if a market participant meets the correlation test, they could still be prohibited from trading in a particular sovereign CDS simply because the instruments were issued in a different Member State.¹⁸⁶ This

¹⁸² With respect to the US in particular in this regard, see further John Coffee, 'The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated' (2012) 97 *Cornell L Rev* 1019.

¹⁸³ AFME and ISDA 37.

¹⁸⁴ 'Short Selling and CDS Regulation in EU: Less to Nakedness Than Meets the Eye, Funds and Firms Argue' *Reuters* (5 March 2012).

¹⁸⁵ Deutsche Bank, *ESMA Call for Evidence* 9. In particular it limits the use of such sovereign CDS indices to cross-country hedge credit value adjustments (these account for the possible default of the counterparty regarding exposures in several Member States). This is also counter to the EU banking reforms that include the use of index CDSs for the purpose of mitigating such risk.

¹⁸⁶ AFME and ISDA (n 158) 37.

sits very uncomfortably with the vision of a single European financial market and could in fact provide a disincentive in relation to cross-border business. For instance it could encourage companies to conduct business in their home Member State because counterparties would be better able to hedge their exposures to entities in their home Member State.¹⁸⁷

Further, despite ESMA observing that it was the co-legislators' intention that the geographical scope of the rules should not be drawn too widely, when one considers the wording of the Regulation itself, it does not explicitly state that hedging can only be within one Member State.¹⁸⁸ Article 4 is silent on this issue, and recital 21 states that such interests 'include' hedging against the risk of default of a sovereign issuer. Recital 21 then provides examples of a wide range of exposures that could be eligible for hedging and although the recital does refer to hedging exposure 'in the Member State concerned' this is arguably also an example rather than a requirement that hedging can only be within one Member state.¹⁸⁹

Finally it is also ironic that an opt-out has been included in the event that the CDS restrictions increase the cost of borrowing for sovereign issuers when this was precisely the rationale behind introducing the provisions in the first place. Indeed, there is also an added paradox in that it is precisely at the times when such opt-out

¹⁸⁷ Ibid 37.

¹⁸⁸ Managed Funds Association (n 159) 11-12.

¹⁸⁹ Ibid 12. Indeed, when the Delegated Regulation was being drafted there were considerable differences of view as to whether cross-border hedging was permissible. For instance a member of ESMA's board of supervisors was quoted as saying that although it was not entirely clear from the wording of the Regulation whether cross-border hedging was exempt or not, ESMA had received a 'very strong position' from the Commission's legal services that it was not exempt, see e.g. 'Short Selling and CDS Regulation in EU: Less to Nakedness Than Meets the Eye, Funds and Firms Argue' (n 184) 2.

powers can be exercised with respect to sovereign CDSs that regulators may be also restricting other forms of short selling.¹⁹⁰

Given the short period the Regulation has been in place, plus the improved situation in the sovereign debt markets, it is recognised that it is hard to fully ascertain the effect that the sovereign CDS restrictions have had.¹⁹¹ Indeed the actual impact on the underlying sovereign bond markets may only become truly evident during a future period of market volatility.¹⁹² Nonetheless it remains clear that these rules move in the wrong direction: the restrictions have driven parties away and the rules may also reduce investor interest in the underlying bond market in many countries. This could raise the cost of debt issuance for such sovereign issuers: precisely what the rules were seeking to prevent.¹⁹³ Finally, although commercial parties may work out how to ‘game’ the rules to their advantage going forward, this does not excuse the introduction of a patently unreasonable ban in the first place.

6.7 Conclusion

¹⁹⁰ Juurikkala (n 112) 337-8. Further, such decisions may not necessarily be made by the same regulator. For instance the relevant competent authority for sovereign CDSs are covered by the regulator of the Member State to which the CDS relates. In contrast the relevant competent authority for shares and other financial instruments is the national regulator controlling the most relevant market in terms of liquidity for that instrument, see Regulation 236/2012, art 2(1)(j)(i) and (v).

¹⁹¹ Indeed it has also been observed that peripheral sovereigns were more stable following the announcement of the outright monetary transactions (‘OMT’) plan by the European Central Bank (‘ECB’) in September 2012. Broadly this plan enables government bond buying by the ECB: it can engage in OMTs to address distortions in the government bond markets provided the country complies with certain strict requirements in relation to their economic policies, see e.g. ‘ECB’s Mario Draghi Unveils Bond-Buying Euro Debt Plan’ *BBC News*, (6 September 2012).

¹⁹² AFME and ISDA (n 158) 10-11.

¹⁹³ AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (15 March 2013) 11; IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 17. This is particularly so where such countries do not have alternative markets for expressing views about negative sovereign credit risk.

The unsubstantiated accusations that speculative CDS activity aggravated the financial problems of sovereign issuers during the recent sovereign debt crisis have resulted in the introduction of a permanent prohibition on all naked sovereign CDS activity. Indeed, the Regulation's restrictions go much further than only prohibiting uncovered positions and also eliminate much legitimate hedging activity. Market participants are rightly anxious of breaching opaque correlation tests, and the geographical limitations are of particular concern, running counter to the principles behind a single European market.

As with the restrictions on short selling we observed in Chapter 4, the prohibition on uncovered sovereign CDS positions moves in the wrong direction, and market participants, including those not targeted by the ban, are withdrawing from the market.¹⁹⁴ Activity will simply be transferred to other less transparent markets, and the restrictions may also have the unintended consequence of reducing interest in the sovereign bond market. The economic literature and evidence that we have considered in this chapter does not support the introduction of a ban: rather it would have been far more sensible to have engaged in tackling the underlying fiscal problems of particular Member States than simply seeking to prohibit the symptoms of the problem.

¹⁹⁴ IMF, *A New Look at the Role of Sovereign Credit Default Swaps* (n 16) 21.

Chapter 7: Conclusion

7.1 Introduction

It is important to now step back from the detail in the previous substantive chapters. Chapter 7 completes the thesis by providing some general observations based on the thesis' findings. It also answers the thesis' core question, concluding that the Regulation's introduction is unjustified and that it particularly reflects short-term political point scoring triumphing over the long-term benefits of market efficiency. The conclusion also seeks to place the Regulation's introduction within the broader European picture. With this in mind, it is evident that the Regulation provides an excellent illustration of the 'more Europe' approach to financial regulation that has come to dominate the post-crisis period. Nevertheless it is also clear that such an approach also introduces its own challenges and potential dangers, not least that of 'systemic regulatory error'.¹

7.2 Concluding General Observations

To return to first principles, it is vital to remember that the economic literature almost overwhelmingly endorses the importance of both conventional and naked short selling activity for efficient markets, and that restricting short selling prevents markets from being more efficient. Indeed, despite regulators' fixation on the need to restrict naked short selling, and the fundamental distinction the Regulation draws between naked

¹ Jennifer Payne and Elizabeth Howell, 'The Creation of a European Capital Market' in Panos Koutrakos and Jukka Snell (eds), *Research Handbook on the Law of the EU's Internal Market* (Edward Elgar forthcoming 2015) 29-30.

and covered short selling, naked short selling is not a special case, and there are not stronger justifications for its regulation.

Returning to short selling's contribution to market efficiency, as we observed in Chapter 2, through short selling's information revealing properties, this will push securities to a lower and more efficient level.² Although regulators seek to prevent this occurring through using short sale restrictions, this is actually what we want short sellers to do. Indeed rather than being a suspect activity, short selling 'confers a positive externality' on the market, by speeding up the reflection of unfavourable information into prices.³ Likewise, short selling's contribution to market efficiency is also increased through it enhancing liquidity and trading opportunities. Further, short selling can also act as a 'market sanction' to discipline reckless behaviour by management, and the quicker the market sanctions such behaviour, the better.⁴ Short selling activity also helps smooth market bubbles, and reduces the risk of even greater price corrections, and of any subsequent distress or market crash.⁵

The empirical data also suggests that short selling constraints do not achieve their objective of artificially supporting prices and that they could in fact aggravate a price decline, as the unrevealed negative information of investors who would have

² Ronald J. Gilson and Reiner H. Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' (2003) 28 J Corp L 715, 727.

³ Ibid 738.

⁴ Broadly, by permitting negative information to be rapidly and fully incorporated into prices, prices are in a condition to more effectively react to managers' poor performance and as a consequence the market disciplining effect on managers is enhanced, Luca Enriques and Sergio Gilotta, 'Disclosure and Financial Market Regulation' in Eilis Ferran, Niamh Moloney and Jennifer Payne (eds), *The Oxford Handbook on Financial Regulation* (Oxford University Press 2014) 20.

⁵ Essentially the lesson to be learned is that active investors are required and that short selling restrictions slow down the price discovery process, prolong price imbalances and, in the long run worsen crises, see HFSB, *HFSB Response to the European Commission Public Consultation on Short Selling* (2010) 3-4.

engaged in short selling only emerges when the market begins to fall.⁶ Consequently, as we observed in both Chapters 2 and 4, there is very good reason to be critical of the short selling constraints that have now been introduced. Indeed, the Regulation's permanent restrictions, although not expressed as such, constitute a de facto ban on naked short selling. In contrast, although the Regulation's new settlement rules can be broadly welcomed as a sensible means of tackling this risk, the discussion has also moved on with the introduction of broader European legislation on securities settlement that repeals the short selling settlement provisions.

Next, although the Regulation's private notification rules can in principle help assist regulators in enhancing their understanding as to the effects of short selling and in monitoring for cases of abusive behaviour, in practice such requirements may prove to be costly and ineffective. Public disclosure rules also come with a considerable number of drawbacks and constitute a de facto short selling restriction above the relevant public disclosure threshold. Problems with the implementation of these rules within the EU (an issue not limited to reporting requirements) has also created significant operational burdens in practice and also runs counter to the vision of harmonised rules throughout the Union.

Further, although the naked short selling constraints and disclosure rules operate at all times, the Regulation also provides powers for NCAs to impose a range of measures in emergency situations. Such tools include the ability to prohibit all forms of short sales plus circuit breaker powers. Although ESMA has an important

⁶ See e.g. Harrison Hong and Jeremy C. Stein, 'Differences of Opinion, Short-Sales Constraints, and Market Crashes' (2003) 16 Rev Fin Stud 487. Consequently, arguments that short selling in fact aggravates price falls are not borne out by the empirical evidence.

coordinating role in this regard, in the absence of intervening itself, it also has no real authority to prevent NCAs implementing incoherent approaches and, as we observed in Chapter 4, this has proven problematic in practice. Likewise ESMA's direct intervention powers under the Regulation are also an important new development, and although there is a serious argument to be made for a uniform cross-border response in the event that short selling constraints are to be imposed, ESMA's new role also raises important legal questions.

Specifically, although the ECJ thought otherwise, ESMA's direct intervention powers that overrule prior decisions of a NCA are less a measure contributing to harmonisation but rather the replacement of national decision making with EU level decisions. As Chapter 4 observed, this case also raised broader issues including the likelihood of greater centralisation of powers at the European level. Further we should also question how much further article 114 can continue to be stretched in the arena of European financial market regulation without asking whether a Treaty change is required. Indeed and on a related point, the choice of the article 114 Treaty basis to adopt the Regulation in the first place should also be questioned. Specifically, as Chapter 4 discussed, this Treaty basis ties measures of harmonisation to the establishment and functioning of the internal market and it can rightly be asked whether short selling prohibitions in fact facilitate the fundamental freedoms and the functioning of the single market.

Next, and in line with what we have observed in earlier chapters, there is also no justification for European policymakers taking a different approach to long rather than short selling. As we observed, it is the long traders who can create market

bubbles, and it was long rather than short sellers who accounted for most of the downward price pressure during the recent financial crisis. Issues of market manipulation arise in relation to both long and short positions, yet in the EU it is currently only the short sellers that face additional ex ante short sale restrictions. Likewise the current disparity in the EU between the requirements for long and short position reporting with more onerous, lower thresholds being placed on short rather than long positions could also, unintentionally and inadvertently, result in greater herding behaviour.

Further, as the thesis has emphasised, the short selling rules now in place in the EU have particularly suffered from the politicisation of the legislative process. Specifically, the inclusion in the Regulation of sovereign bonds and sovereign CDSs and the exclusion of corporate equivalents particularly illustrates the politicisation of the rules in the light of the sovereign debt crisis. Indeed this is further reiterated when one also notes that there has been no similar push to regulate the short selling of sovereign debt in the US. Likewise there is no justification behind the different approach taken in the rules to the short selling of shares and sovereign debt. Indeed the lighter set of restrictions on the short selling of sovereign debt merely reflects political concerns about the ability of Member States' to raise finance. Further, the numerous technicalities and complexities introduced in the accompanying administrative regulations especially underlines the juggling of political concerns with the desire to also preserve legitimate risk management and hedging activity.

Currently however the 'boundary problem' will simply result in participants engaging regulatory arbitrage including moving to overseas markets; the utilisation of

corporate rather than sovereign CDSs; and the use of options and other derivatives where possible rather than ‘pure’ short sales to achieve a functionally equivalent outcome. Indeed with this in mind, the only reason that options and other such strategies were not also included within the Regulation’s core restrictions was likely down to the fact that the public found short selling morally reprehensible but could not understand or comprehend more complex strategies involving, for instance, put and call options.

Based on ESMA’s evaluation of the Regulation, the Commission has now proposed a subsequent review of the rules on the basis of more evidence at the end of 2016. Although ESMA’s 2013 evaluation could only consider a limited amount of available empirical data since the Regulation’s adoption, it did (as we observed in Chapter 4) find that price discovery had deteriorated and that the securities lending market may have been adversely affected by the locate rule. Notably as well, ESMA also identified a number of issues where changes could help alleviate parties’ operational challenges (including for instance creating a centralised reporting platform). Nevertheless the Commission chose to postpone any such changes until its second review.

On a broader point it is also acknowledged that it may prove tricky to try and roll back the Regulation’s main provisions further down the line. Although, in Chapter 3 we noted that strong lobbying pressure from the financial services industry could assist in subsequently watering down legislation,⁷ it is unclear how this translates across the Atlantic in relation to the repeal of the European rules. Rather,

⁷ John Coffee, ‘The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated’ (2012) 97 Cornell L Rev 1019.

what might be more realistic (as considered in Chapters 4 and 6) could be the potential over time for watering down some of ESMA's narrow technical advice and associated administrative rules. Ultimately however it appears likely that the Regulation's core provisions will remain in place for the foreseeable future.

Finally, and more generally, any short selling rules are going to prove ineffective and capable of regulatory arbitrage where there is not a uniform global approach. Although, throughout the thesis, we have observed some functional consistencies between the European and US rules, including with respect to restricting the naked short selling of securities, we have also come across a number of inconsistencies (not least with respect to the regulation of the short selling of sovereign debt) and in this regard the European rules do relatively little to close this gap.⁸

7.3 The Big Picture

Returning then to the broader European picture, it has often been maintained that the regulatory backlash following a crisis creates an opportunity to push through reforms that have little true connection to the actual crisis,⁹ and the Regulation's enactment appears to support this suggestion. As we have observed throughout the thesis, the politicisation of regulation has considerably increased since the crisis, meaning it was ever more likely that unhelpful and costly rules would be imposed on parties in the name of enhancing financial stability. In this regard we have also observed the rise of

⁸ Jennifer Payne, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 EBOR 413, 440.

⁹ See e.g. Eilís Ferran, 'After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU' (2011) 12 EBOR 379.

a more ‘trading ban’, interventionist attitude to regulation illustrated in the Regulation by its de facto ban on uncovered short selling (including on uncovered sovereign CDSs) plus the addition of a host of temporary market intervention tools. This approach can be contrasted starkly with the ‘regulatory pause’ that characterised the ‘Better Regulation’ phase of European financial regulation in the pre-crisis years,¹⁰ as well as with the rejection of the pre-crisis light-touch approach to regulation that was often associated with the UK.

As we observed in Chapter 3, the European Parliament’s (the ‘Parliament’) strong anti-speculation agenda and active role in shaping the final short selling rules is also particularly notable, a stance that has also not been limited to short selling regulation. For instance in the context of the progress of Alternative Investment Fund Managers Directive (‘AIFMD’), although the Parliament adopted a more nuanced approach, it still succeeded in securing significant restrictions that were more intense than the Commission’s starting point.¹¹ Indeed going forward it is likely that the Parliament’s ‘pro-regulation’ stance will continue to influence policy and laws within the EU’s financial market for some time to come.¹²

ESMA’s role in the Regulation also provides an important illustration of the changes that have taken place with respect to the Europe’s institutional framework. Specifically ESMA is one of three new European Supervisory Authorities (‘ESAs’) created post-crisis that are part of a broader integrated network of European financial

¹⁰ See e.g. European Commission, ‘White Paper: Financial Services Policy 2005-2010’ (COM(2005)629).

¹¹ Ferran (n 9) 413-414.

¹² Niamh Moloney, ‘EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?’ (2010) 47 CML Rev 1317, 1138-39.

supervisors,¹³ and (as we have already touched on) ESMA's new powers, both within the Regulation and more generally, considerably extend its authority beyond that granted to its predecessor CESR. Such changes demonstrate a huge step forward for the European financial market project, including with respect to European intervention in the markets, and for this reason these developments have been controversial. Indeed although as we have already discussed, there is an argument to be made for centralising powers in the event that temporary short selling constraints are to be imposed, in other circumstances the justifications for centralising powers may be weaker. Consequently it should also be queried whether short selling was in fact a sensible model for the ECJ taking broader decisions with respect to the centralisation of powers in the ESAs.

Finally, and more generally it is also clear that the Regulation provides an apt illustration of the 'more Europe', 'more regulation' approach that has defined the post-crisis period. Specifically, as we have observed in earlier Chapters, the crisis prompted the EU down the path of more intensive regulation, favouring greater harmonisation and a vastly expanded regulatory arena. There has also been a clear shift in rhetoric post-crisis from one of liberalisation and the breaking down of market barriers, to one that focuses on the benefits of integration as a means of managing risks. Nevertheless it is also worth pausing to remember that although the crisis perhaps demonstrated the need for greater levels of harmonisation, it also illustrated the dangers of integration with the sovereign debt crisis providing one key example. Consequently, perhaps the greater levels of centralisation and the vast number of new

¹³ These changes stemmed in part from the de Larosière report, see e.g. Jacques de Larosière, *The High-Level Group on Financial Supervision in the EU: Report* (2009) 47.

rules on the table introduce their own dangers, not least that of systemic regulatory error.¹⁴

7.4 Final Remarks

The introduction to this thesis observed that short selling is a sensitive subject and the issue of short selling regulation is sometimes described as a subject that generates more heat than light.¹⁵ Views have differed on short selling since the 17th century,¹⁶ and this debate has not changed in the 21st century where policymakers and the public continue to instinctively feel that short selling is intrinsically wrong.

Nevertheless as this doctorate has illustrated, the justifications in favour of short sale restrictions simply do not stand up to scrutiny in the harsh light of day. Financial economists have extensively researched short selling and the imposition of short sale restrictions and this research has been remarkable for its largely consistent conclusion that short selling enhances market efficiency. As this thesis has emphasised, such benefits are far more intricate and long term in nature than any short-term post-crisis political point scoring when it is considered to be ‘en vogue’ to be against speculators.

¹⁴ Jennifer Payne and Elizabeth Howell, ‘The Creation of a European Capital Market’ (n 1) 29-30.

¹⁵ Merritt B Fox, Lawrence R Glosten and Paul C. Tetlock, ‘Short Selling and the News: A Preliminary Report on Empirical Study Fear, Fraud, and the Future of Financial Regulation Symposium’ (2009) 54 New York Law School Law Review 645, 646.

¹⁶ See e.g. Arturo Bris, William N. Goetzmann and Ning Zhu, ‘Efficiency and the Bear: Short Sales and Markets around the World’ (2007) 62 J Fin 1029 and the discussion of the profitable shorting of shares in the Dutch East India Company that angered shareholders and led to the first short sale regulations being enacted in 1610.

This thesis has demonstrated that the Regulation is not a justifiable response to the concerns posed by short selling, and that the politicisation of regulation and the resulting regulatory choices have led to a complex set of rules that hinders valuable short selling activity and will mean markets are less efficient. As the thesis has discussed, although commercial parties may learn to game the system to their advantage, this does not justify the introduction of patently unreasonable rules in the first place. One should be wary of knee-jerk regulatory reforms, and in this regard it is the policymakers, not the speculators, who have sold us short.

Appendices

Appendix 1

Overview of Main Empirical Studies: Short Selling and Market Efficiency

Jones and Lamont (2002)	
Period	Jan 1926-July 1933
Purpose of Study	Authors use evidence on the cost of short selling securities to explore overpricing and market efficiency.
Data Set	Authors use 8 years of data on stock loan rates for NYSE stocks using a publicly observable market for borrowing stock. ¹ They collect data on an average of 90 actively traded stocks per month. ²
Main Findings	Stocks that are expensive to short have low subsequent returns consistent with the overpricing hypothesis. Stocks that newly enter the borrowing market exhibit substantial overpricing. Prices rise prior to entering the loan list and subsequently fall as the apparent overpricing is corrected. ³

Bris, Goetzmann, and Zhu (2007)	
Period	Jan 1990-Dec 2001
Purpose of Study	Authors consider whether short selling constraints affect market efficiency at the country level using differences in short selling regulations across countries.
Data Set	Authors consider information ⁴ from 46 equity markets around the world for an 11-year period. They use two measures of market efficiency based on asymmetries in individual stock responses to market returns. ⁵
Main Findings	Authors find evidence using both market efficiency measures that prices incorporate information faster when short selling is allowed as bad news is more rapidly impounded into prices.

¹ During the period under examination, stock lending for some stocks takes place through a centralised market on the floor of the NYSE (this market no longer exists).

² The loan rates represent the direct monetary costs of shorting a stock and they reveal which stocks are in demand by short sellers.

³ The authors find that the loan crowd entrants underperform by more than the costs of shorting so shorting is a profitable strategy even after paying the associated costs. Thus the stocks are more overpriced than can be explained by measured shorting costs alone.

⁴ The authors obtain information regarding the history and current practice of short sale restrictions from regulators, investment banks and institutional investors specialising in short sales.

⁵ The authors measure market efficiency at the individual stock level by computing the co-movement of individual stock returns and the market, and also measure the correlation of individual stock returns with past stock returns.

Fotak, Raman, Yadav (2010)	
Period	1 Jan – 1 July 2007 ⁶
Purpose of Study	Authors investigate the impact of naked short selling on liquidity and pricing efficiency.
Data Set	Authors consider daily data based on outstanding FTDs as a proxy for naked short selling for the first half of 2007, and use a random sample of 375 NYSE securities. ⁷
Main Findings	The authors find that naked short selling has a significantly beneficial effect on pricing efficiency and liquidity. They also focus on a sample of the most naked shorted securities and even then find a positive impact on market quality. Authors also find that the positive impact in reducing the mispricing of overpriced securities applies equally to both covered and naked short selling.

Saffi and Sigurdsson (2011)	
Period	Jan 2005-Dec 2008
Purpose of Study	Authors examine how stock price efficiency is affected by short selling constraints, and focus on how individual firms rather than countries are affected by short sale constraints.
Data Set	Authors use weekly equity lending transactions across 26 countries including more than 12,600 stocks.
Main Findings	Stocks with higher short sale constraints measured as lower lending supply are associated with lower price efficiency but are not more stable. Relaxing short sale constraints (measured as a high level of lending supply and to a lesser extent low loan fees) is also not associated with increasing price instability.

⁶ See also Appendix 2 for Fotak et al's findings with respect to naked short selling and the financial crisis, and Appendix 3 for the authors' findings with respect to manipulative short selling.

⁷ The authors note there are imperfections to this proxy but consider that although, for example, human and processing errors can lead to FTDs rather than naked short selling, such errors would be random and would only add some noise rather than affecting the conclusions. Further the literature supports the use of FTDs as a good proxy.

Appendix 2

Overview of Main Empirical Studies: Financial Crisis and Short Selling

Studies on Short Selling Bans in the US and Worldwide

Bris (2008)	
Period	1 July 2006 – 8 Aug 2008 ¹
Purpose of Study	Bris studies the effect of the US emergency ban in July 2008 on the naked short selling of stocks of 19 financial firms (the ‘G19 stocks’).
Data Set	Author compares the G19 stocks to a control sample of financial institutions from the US and abroad (all listed in the US) both before and after the ban is in place, and analyses the impact of the ban on the efficiency of the markets. ²
Main Findings	The negative returns of the G19 stocks before the ban cannot be attributed to short selling, and market efficiency (including liquidity) declines overall after the ban becomes effective. The efficiency of the G19 stocks also deteriorates more than the efficiency of comparable US financial stocks.

Fotak, Raman, Yadav (2010) (Part 1)	
Period	1 Jan – 2 Sept 2008
Purpose of Study	Authors study the market impact of the US emergency ban in July 2008 on the naked short selling of stocks for 17 out of the 19 stocks subject to the ban. ³
Data Set	Authors compare the stocks to a control sample of 17-market capitalisation and industry-matched stocks.
Main Findings	Authors find significantly higher pricing errors and significantly lower trading volumes once the ban is in place indicating the ban hampered price discovery and reduced liquidity. They also find that the ban fails to slow price declines of the affected securities.

¹ The findings highlighted here focus in particular on the impact of the July 2008 temporary ban on market efficiency.

² The author follows Bris, Goetzmann and Zhu (see Appendix 1) with respect to market efficiency measures. Bris observes that in more efficient markets individual stock returns co-move less with the market and are less correlated to past returns as information is impounded into prices immediately.

³ Two of the firms subject to the ban traded over-the-counter and the data obtained from the Centre for Research in Securities Prices (‘CRSP’) database did not include such securities.

Fotak, Raman, Yadav (2010) (Part 2)	
Period	2008
Purpose of Study	The authors analyse naked short selling surrounding the demise of financial firms including Lehman Brothers.
Data Set	Authors use daily data based on outstanding FTDs as a proxy for naked short selling. They also identify 4 financial institutions with the closest market value as Lehmans as control variables. ⁴
Main Findings	The authors find abnormally low naked short selling in the days leading to September 9 th . It is only after September 10 th , following widespread coverage of the negative news about Lehmans and the associated price crash, that naked short selling intensifies. The analysis indicates that the incidence of naked short selling, even at its peak, is too low to justify the share price decline. ⁵

Office of Economic Analysis (2008)	
Period	Sep 2008
Purpose of Study	Analyses the 13-day period preceding the September 2008 temporary short selling ban to examine the extent short selling appears to drive prices downward during this period.
Data Set	Studies 196 firms that are then subject to the ban plus a control sample of 198 firms not subject to the ban. Uses intraday data on trades and quotes. ⁶
Main Findings	Results are inconsistent with the notion that episodes of extreme negative returns are a result of short selling behaviour. During such periods sell pressure is more intense for long trades.

⁴ The authors compute the daily outstanding naked short ratio for the benchmark institutions and subtract it from Lehman's outstanding naked short ratio and test this for statistical significance.

⁵ The authors conduct similar analysis with respect to Bear Stearns, Merrill Lynch, and AIG. For Merrill Lynch and AIG the incidence of naked short selling is so small they do not engage in statistical testing. With Bear Stearns, when naked short selling intensifies, it is after the public announcement of negative news and the consequent price drop, not before, indicating naked short sellers are responding to public information and are not responsible for triggering the price falls.

⁶ The authors also use CRSP data to estimate market capitalisation, and self-regulatory organisation data to estimate short selling levels.

Boehmer, Jones, and Zhang (2013)	
Period	1 Aug 2008 – 31 Oct 2008
Purpose of Study	Studies the effect of the US emergency order in September 2008 that temporarily banned most short sales (there was a limited exception for market makers) in almost 1000 financial stocks.
Data Set	Analyses the US equity market in depth. Uses intraday data on trades and binding quotes to compute standard measures of market quality including bid-ask spreads, price impacts (a measure of illiquidity) and intraday volatility and link this to ban induced changes in short selling intensity. ⁷
Main Findings	On the ban's announcement the authors observe a large price increase for banned securities but recognise this could be due to the associated announcement of TARP. For firms subsequently added to the banned list the authors find no price jump and that the stocks consistently underperform while the ban is in place. This suggests the ban did not provide an artificial boost in prices. The authors also find that all but the smallest securities subject to the ban suffer a severe degradation in market quality.

Beber and Pagano (2013)	
Period	Jan 2008 – June 2009
Purpose of Study	Explores the variation in short selling regulatory interventions introduced around the world. The primary focus of the study is the effect of the short selling bans on market liquidity but they also investigate other dimensions such as price discovery and the level of stock prices.
Data Set	<p>Authors use a daily data set for 16,491 stocks in 30 countries. For each country the authors determine whether a short selling ban was enacted, if so when it was enacted, which stocks it applied to, and which restrictions it imposed on short sales.</p> <p>The data is broader than the Boehmer study but the breadth of this study also confines the analysis to broadly available data.⁸ Owing mostly to data confines, the authors mainly examine how regulatory interventions differ across countries.</p>
Main Findings	The authors find the bans are responsible for a statistically and economically significant deterioration of market liquidity, and that the bans slow down price discovery, particularly during overall market declines. They also find that the bans fail to support prices and are not associated with better stock price performance, with the possible exception of US financial stocks. Again this can be explained by the confounding effect of the TARP announcements. In countries other than the US, temporary short selling bans are associated with either no significant change or a decline in stock returns.

⁷ The authors also use daily data on actual short selling flows to gauge the extent the ban is effective in reducing short selling across stocks and how this reduction affects market quality.

⁸ For instance the authors use prices and indicative (potentially non-binding) end of day quoted spreads from Datastream rather than actual intraday transaction costs. In contrast Boehmer et al. use intraday data on trades and binding quotes.

UK Studies

Clifton and Snape (2008)	
Period	23 June – 30 Oct 2008
Purpose of Study	Authors examine the effects on market liquidity following the FSA's decision to ban temporarily short selling in selected financial and insurance securities in September 2008.
Data Set	Authors survey measures of market liquidity in the banned stocks against a control sample of stocks not subject to the ban. ⁹ Variables are measured in two pre-ban periods and then again following the imposition of the short selling restrictions.
Main Findings	The authors find that restricted securities exhibit a statistically significant deterioration in liquidity that is not explainable by market wide changes such as increased volatility. Significant declines in depth, trade, volumes, and turnover are also observed.

Marsh and Niemer (2008)	
Period	1 Jan – 31 Oct 2008
Purpose of Study	Authors examine the impact of short selling restrictions on the behaviour of stock returns in the UK. To place the results in a wider context, the authors also consider a sample of five other countries that adopted different degrees of short selling restrictions. ¹⁰
Data Set	Authors use stock return data and select a 'universe of stocks' in each country (i.e. in the UK, the authors use the FTSE 350). The authors divide stocks into those stocks restricted and those unrestricted by the ban before and after the restrictions are imposed in a particular country. They calculate a number of metrics to help assess the impact of the restrictions. ¹¹
Main Findings	The authors find no strong evidence that short selling restrictions in the UK or elsewhere changed the behaviour of stock returns.

⁹ The authors broadly define market liquidity as the ability to buy and sell significant quantities of a security quickly, at low cost, and with relatively low price impact. They calculate several market liquidity measures including the bid-ask spread, the bid-ask depth (the volume required to move the bid and ask price by 1 per cent for each stock), trades and volumes (number of trades and number of shares traded), and turnover (number of shares transacted divided by the number of shares on issue).

¹⁰ US, France, Germany, Sweden, and Japan.

¹¹ Such metrics include the mean and the median daily returns, their standard deviation, skewness (how asymmetric the distribution is), and kurtosis (a measure of volatility).

Appendix 3

Overview of Main Empirical Studies: Short Selling and Manipulative Behaviour

General Findings

Fotak et al. (2010)	
Period	2008
Purpose of Study	Authors examine whether manipulative naked short selling and its impact increase during the financial crisis.
Data Set	Authors analyse a proxy for the impact of manipulative naked short selling during the 2008 crisis and compare this to the first half of 2007. The definition of potentially manipulative naked short selling is based on whether it is undertaken when pricing errors or order-imbalances ¹ are negative. ²
Main Findings	Authors find that manipulative naked short selling did not increase from the first half of 2007 to the 2008 financial crisis. ³

Boehmer and Wu (2013)	
Period	Jan 2005 – Dec 2007
Purpose of Study	Within a broader study on short selling and price discovery, the authors examine short selling around large price movements and price reversals. They note that extreme price movements are useful for evaluating the motivation for short selling.
Data Set	Authors use daily observations of short sellers' trading activity. ⁴ For 'extreme' returns, the authors select days with returns exceeding two standard deviations measured over the past 20 trading days.
Main Findings	Overall the results are consistent with short sellers acting as contrarians: short sellers' trading help accelerate price discovery during extreme events. They find no evidence of manipulative trading by short sellers.

¹ Order-imbalance is defined as the difference between the market value of shares traded in buyer-initiated trades and the market value of shares traded in seller-initiated trades divided by total daily trading volume.

² The authors observe it is difficult to precisely define criteria that classifies naked short selling as potentially manipulative. They note that when naked short selling is undertaken when pricing errors are negative this could arguably amplify pricing errors (i.e. could contribute to generating a bear raid). Likewise, if it is initiated when order-imbalances are negative it could cause them to become even more negative.

³ The authors also compare these periods with a 2004 period pre Regulation SHO (broadly this introduced a regulatory framework for short sales in the US) and found that manipulative naked short selling was significantly lower in 2007 and 2008 than in the 2004 period.

⁴ The authors use shorting flow data obtained from the NYSE for domestic stocks. They also use CRSP data to obtain daily returns, trading volume, prices, and shares outstanding. On an average day the final sample covers 1,361 stocks.

Seasoned Equity Offerings ('SEOs')

Safieddine and Wilhelm (1996)	
Period	1980-1991
Purpose of Study	Authors investigate rule changes in the US (adoption of Rule 10b-21 ⁵ in 1988) designed to curb manipulative short selling around SEOs.
Data Set	Authors consider SEOs for NYSE and AMEX listed firms using monthly short interest reports produced by the exchanges. ⁶ The final sample consists of 474 issues: 409 by NYSE listed firms and 65 by AMEX listed firms.
Main Findings	Authors find that SEOs are characterised by abnormally high levels of short selling. The adoption of Rule 10b-21 helps curb such practices and reduces their cost.

Kim and Shin (2004)	
Period	1983-1998
Purpose of Study	Authors observe the impact of Rule 10b-21 on the pricing of US SEOs.
Data Set	Authors examine over 3000 SEOs and compare the period before and after Rule 10b-21 is adopted. To identify the impact of short selling (if any), they examine negative excess returns for the 5-day period preceding the issue day as such returns reveal short selling. ⁷
Main Findings	Overall, the authors find significant SEO discounts once Rule 10b-21 comes into effect. It also appears that manipulative short selling is either non-existent, or occurs on a very small scale (price decreases are permanent). Authors also observe that as the rule constrains all short sellers of the SEO issuing firm, pre-market prices for SEOs may be less informative, which could cause SEOs to be offered at discount prices.

⁵ Rule 10b-21 (part of Regulation M) prohibited using shares purchased in a SEO to cover short positions. The rule applied to any short sale established between the initial filing and the offer date.

⁶ They observed that the NYSE sample reflects a selection bias towards firms exhibiting a relatively high level of short interest.

⁷ The authors also noted a serious sample selection bias with the Safieddine et al. study: Safieddine's short interest measure does not always reflect short interest established immediately before the offer date and it also excludes SEOs for which monthly data is not available.

Henry and Koski (2010)	
Period	Jan 2005 – Dec 2006
Purpose of Study	Authors examine Rule 105 that replaces and relaxes Rule 10b-21. ⁸
Data Set	Authors consider a sample of 414 SEOs and the authors use transaction level short sale data aggregated to the daily level.
Main Findings	Around issue dates, higher levels of pre-issue short selling is significantly linked with larger issue discounts in traditional SEOs both when unconstrained and when constrained by Rule 105. Suggests Rule 105 has not effectively eliminated all manipulative short selling closer to the issue date.

Autore and Gehy (2013)	
Period	2005-2009
Purpose of Study	Authors examine an amendment to Rule 105 that strengthens it and aims to eliminate trading strategies that evaded the former rule. ⁹
Data Set	Authors consider a sample of SEOs containing 1028 observations (traditional and shelf-registered offerings). Also examines the US September 2008 temporary ban that discourages broker-dealers from allowing customers to engage in naked short sales.
Main Findings	The amendment has an adverse impact. As it excludes potential buyers, it makes it more difficult for underwriters to place offers in overnight deals and leads to greater discounting. Authors also find that the September ban is associated with large increases in SEO discounting for offers announced in advance. Findings are consistent with assertions in prior work that naked short sellers are not manipulative traders.

Jones et al (2013)	
Period	Beginning of disclosure regimes ¹⁰ – June 2011
Purpose of Study	Within the context of a broader study of disclosure regimes introduced in UK, France, and Spain following the crisis, the authors examine rights issues and explore whether manipulative shorting behaviour takes place.
Data Set	Examine 86 rights issues (84 in the UK and 2 in Spain) during the sample period using data obtained from Data Explorers and matches firms to control firms that did not undergo a rights issue and did not have a disclosed short position over the sample period.
Main Findings	Price declines during rights issues in the UK are not the result of manipulative short selling. If short sellers are manipulating prices there would be a price reversal once the rights issue is completed. ¹¹

⁸ Rule 105 prohibits traders from covering short sales made within five days of the offering with shares obtained in the offering.

⁹ Under the amended rule a person who opens a short position in the five days prior to issuance cannot purchase shares in the SEO, regardless of whether the shares are used to cover a short position.

¹⁰ The disclosure regimes for the UK, France, and Spain begin on January 2009, February 2011, and June 2010 respectively.

¹¹ The authors also suggest that disclosure could serve as an alternative to the imposition of shorting restrictions.

Appendix 4

Chapter 5 Definitions

Term	Definition
Baskets of Securities	A group of securities that are treated as a single unit and traded together.
Consolidated Tape	<p>The Consolidated Tape comprises of Tapes A and B of the Consolidated Tape Plan and Tape C of the Unlisted Trading Privileges ('UTP') Plan.</p> <p>Trades in NYSE-listed securities are reported to Tape A; trades in NYSE-Amex, NYSE-Arca, and regional exchange listed securities are reported to Tape B; and trades in Nasdaq listed securities are reported to Tape C.</p> <p>Transactions in unlisted equities, options, or non-equity securities are not currently reported to the Consolidated Tape.</p>
Delta-Adjusted Model	<p>'Delta' indicates how much a financial instrument's theoretical value is expected to move in case of an underlying instrument's price variation. For example a stock option with options delta of 0.8 would be expected to rise £0.80 with a £1 rise in the underlying stock. It is a relatively simple and informative way of capturing economic exposure but it does have its disadvantages: for example delta varies with the passage of time and with market conditions even if the value of underlying stock does not change.</p> <p>EU Delegated Regulation 918/2012, Annex II provides that derivative and cash positions (i.e. direct short positions in a stock) shall be accounted for on a delta-adjusted basis with cash positions having delta 1.</p>
Exchange Traded Fund ('ETF')	An ETF holds a portfolio of securities or derivatives and aims to track and

	replicate the performance of an index, a commodity, or basket of assets. ETFs trade on the stock exchange meaning they are highly liquid and can be bought or sold by investors on an intra-day basis much like an equity security.
Institutional Investment Manager	Sections 3(a)(9) and 13(f)(6) Exchange Act defines an institutional investment manager as a person investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.
Large Trader	Broadly, this relates to a person whose transactions in NMS securities equals or exceeds 2 million shares or \$20 million during any calendar day, or 20 million shares of \$200 million during any calendar month.
NMS Securities	NMS securities broadly refer to exchange listed securities and standardized options.
NMS Stocks	NMS stocks broadly refer to exchange listed securities other than options.
‘Short Exempt’ Order Marking	Marking an order as ‘short exempt’ reflects the reintroduction of a type of price test in the US in 2010 (i.e. the ‘alternative uptick rule’). Rule 200(g)(2) of Regulation SHO provides that after the 10 per cent circuit breaker is triggered for a security, a sale order is permitted to be marked short exempt if the broker-dealer identifies the order as being at a price above the national best bid at the time of submission.
Short Position	<p>Direct Short Position: a short position taken in the stock itself (also known as a ‘cash position’).</p> <p>Indirect Short Position: Other types of economic exposure to the stock e.g. through the use of derivatives.</p> <p>Net Short Position (‘NSP’): The position that remains after deducting any</p>

	long position a person holds from any short position a person holds in relation to a company's issued share capital.
Short Squeeze	If share prices rise quickly and are sustained for a period then short sellers can be caught in a short squeeze with covering short positions driving prices up further. This can result in substantial losses and can lead to increased volatility.

Appendix 5

Chapter 6 Definitions

Basis points	One basis point is equal to 1/100 th of one per cent. A one per cent change is equal to one hundred basis points.
Basis trading	Arbitrage trading where traders try to exploit pricing differences between CDSs and the underlying debt obligations by taking offsetting positions between the two. For instance, depending on the basis, a trader can purchase the underlying bond and buy CDS protection and lock in a risk-free profit and vice versa.
CDS premium or spread	Specified fee payments the CDS purchaser is obliged to make on an annual basis. If the premium or spread increases, this means that the likelihood of an entity defaulting is increasing.
'Dynamic' hedging strategy	A strategy that accommodates constant changes in risk exposure such as credit value adjustments (such adjustments account for the risk that the creditworthiness of the counterparty deteriorates).
Granger causality tests	Broadly this is a statistical concept of causality based on prediction that can be used in determining a weak form of causality. However such tests can suffer from limitations where variables are omitted.
Hedging 'tail risk' events	Tail risk is similar to an anticipated correlation. Although an asset may not be correlated with a sovereign CDS on a day-to-day basis, it would be expected to have a high level of correlation if there was a tail risk event, such as severe market turmoil. Such hedging is an important risk mitigation tool and is usually encouraged by regulators. In general however it is not possible to use a sovereign CDS to hedge against tail risk events.
Notional amount	The level of CDS protection is usually expressed in terms of a notional amount being protected.
Naked or uncovered sovereign CDS	Where an investor purchases a sovereign CDS without having some kind of

	exposure to the credit risk associated with the underlying bond.
Pearson's correlation coefficient	Broadly this is a statistic that measures the correlation between sets of data. It is a measure (between -1 and +1) of how well the sets of data are related.
Proxy hedging	Hedging risks of other assets whose value is correlated to the value of the sovereign debt.
'Static' hedging strategy	Where the sovereign CDS position is hedging a direct exposure to a sovereign or public sector body in the sovereign.
'Trade tear-ups' (also referred to as 'portfolio compression')	This is an industry technique that broadly means economically redundant derivatives trades are terminated early without changing the net position of each market participant.
Vector Error Correction Model ('VECM')	Cointegrated variables move together in the long run but there can be deviations from each other in the short run, which means they follow an adjustment process towards equilibrium. A model that considers this adjustment process is the VECM. This model also has its drawbacks however: it requires the CDS-bond basis to be sufficiently 'stable' or stationary and therefore limits it to those countries that have a stable basis (far from all countries).

Appendix 6

Overview of Main Empirical Studies: Interaction between the Sovereign CDS and Bond Markets¹

Emerging Markets

Chan-Lau and Sook-Kim (2004)	
Period	March 2001 – May 2003
Purpose of Study	Authors examine whether the bond or sovereign CDS markets lead the other.
Data Set	Authors test a sample of 8 emerging market countries using daily data. ² To undertake cross-country comparisons they used country bond indices ³ and CDS spreads were mid-price quotes on 5-year contracts.
Main Findings	Very mixed results and authors conclude it is very difficult to conclude that one market particularly dominated in terms of price discovery.

Levy (2009)	
Period	Approximately 4 years (between 2000-2008)
Purpose of Study	To explain pricing deviations between sovereign CDS premiums and bond spreads, author focuses on two frictions: liquidity and counterparty risk.
Data Set	Authors use daily data on 5-year sovereign CDS premiums (daily quotes) and 5-year sovereign bond yields (daily quotes) for 16 emerging market countries.
Main Findings	The findings strongly support the relevance of these two frictions to the pricing of CDSs. The relative illiquidity of CDSs has a positive effect on CDS prices and counterparty risk has a negative effect on CDS prices. The findings also support the suggestion that changes in the relative liquidity of the two markets could explain why there was no consistent pattern of one market leading the other: price discovery took place on the market where there was higher liquidity on a given day.

¹ Note that the literature largely adopts a common approach to testing whether the two markets are integrated i.e. it considers whether they are characterised by a long-term stationary relationship and then looks at short-term deviations to this to work out which market adapts to each other. The literature uses either: a standard information measure to assess contribution to price discovery (either a ‘Hasbrouck’ or ‘Gonzalo and Granger’ information measure) that is based on a VECM model; or it uses a ‘Granger causality’ model (a statistical concept of causality based on prediction).

² The authors use both VECM and Granger causality measures. It is recognised that as these are emerging market countries it is difficult to know how generalisable the findings are.

³ Note that using indices lacks the transparency to enable a price comparison between the CDSs and the actual underlying bonds.

Ammer and Cai (2011)	
Period	February 2001-March 2005
Purpose of Study	Authors examine whether the bond or sovereign CDS markets lead the other.
Data Set	Authors use daily data on 5-year dollar denominated sovereign CDS premiums and daily estimates of the yield on a 5-year par coupon dollar sovereign bond. Authors examine 9 emerging economies.
Main Findings	Results suggest sovereign CDS markets seem to lead bond markets in price discovery only in some instances and lag bond prices in others. ⁴ Authors also conclude the relative liquidity of the two markets is a key determinant of where price discovery occurred. ⁵

European Sovereign Debt Crisis

Commission Task Force Report (2010)	
Period	2008-1 st quarter of 2010
Purpose of Study	Examine sovereign CDS activity during the European sovereign debt crisis to examine whether the bond or CDS markets preceded or lagged the other.
Data Set	Empirical analysis of 18 EU countries: 1) Authors use correlation analysis to show whether price changes on one of the two markets preceded the others between 2009-2010. 2) Authors then take this further using Granger causality tests. Examine the period between 2008 - 1 st quarter of 2010. ⁶
Main Findings	No evidence of obvious mispricing in either the CDS or bond markets and CDS spreads are cheap relative to bond spreads. Correlation analysis shows that spreads in the two markets are mainly contemporaneous. Granger causality tests find price discovery is equally likely to occur in either market (for Greece and Italy, the bond market seemed to be the more important market; for Spain and Ireland, the CDS market seemed to be more important; for Portugal it went both ways).

⁴ The authors use the VECM analysis. Again, given these are emerging market countries it is difficult to know how generalisable these findings are.

⁵ Broadly they suggested that as much of the relevant information with respect to sovereign credit risk tends to be in the public domain, new information might be reflected in observed prices more quickly in the more liquid market (cf corporate markets: if this is driven more by informed trading then price discovery may occur in least transparent market that might tend to be less liquid market). This contrasts with Arce et al's findings that are discussed further below, which found that the degree of liquidity does not affect price discovery.

⁶ The report noted the VECM analysis but also observed its drawbacks (i.e. requiring CDS-bond basis to be sufficiently stable and this would limit the analysis to those countries with such a stable basis).

Fontana and Scheider (ECB Working Paper 2010)	
Period	January 2006-July 2010
Purpose of Study	As part of a broader study they analyse which market leads in the pricing process.
Data Set	Although weekly data is used for other aspects of their research, they use daily data on CDS and bond spreads to obtain a better overview of the pricing dynamics. Examine 10-year CDS and bond spreads for 10-euro area countries. ⁷
Main Findings	In line with the Task Force Report, they find in half the sample countries price discovery takes place in the CDS market and in the other half it is observed in the bond market. (They found the bond market has a predominant role in Germany, France, the Netherlands, Austria and Belgium; and the CDS market has a major role for the PIIGS countries).

Delis and Mylondis (2011)	
Period	January 2005-May 2010
Purpose of Study	Examines the interrelation between government bond spreads and CDSs.
Data Set	Daily data on 10-year government bond yields and 10-year euro denominated CDS mid bid-ask prices for Greece, Italy, Portugal and Spain. ⁸
Main Findings	The authors suggest that in times of high stress, investors have a higher preference for less risky and more liquid securities and generally this benefits government bonds as they are typically regarded as less risky than other asset classes. During the debt crisis however, south European bonds become more risky and their spreads to German government bonds soar. The authors conclude that in such times the ‘flight to safety’ to German government bonds becomes more pronounced (fewer would be trading south European bonds and CDSs), disrupting the transmission mechanism from CDS to bond spreads. Notably they conclude that the findings mitigate the common conception of speculative attacks on countries’ default.

⁷ The authors use VECM analysis and used 10-year spreads as this is a common horizon for government bonds.

⁸ Authors used ‘rolling’ Granger causality tests and included an error correction term to account for the existence of cointegration between CDS and bond spreads.

Palladini and Portes (2011)	
Period	January 2004-March 2011
Purpose of Study	Examines the price discovery relationship between CDS spreads and sovereign bond yields.
Data Set	Examines 6 European countries using daily 5-year sovereign bond yields and CDS spreads. ⁹
Main Findings	Findings suggest that the CDS market plays a leadership role in terms of price discovery. Results are more in line with those relating to corporate credit risk.

O’Kane (2012)	
Period	January 2008-January 2011
Purpose of Study	Examine the relationship between sovereign CDSs and bonds.
Data Set	Considers the PIIGS countries and France and examines the daily close prices on 5-year CDSs and bonds. ¹⁰
Main Findings	Finds price discovery is evenly split between the CDS and bond markets. O’Kane finds the dominant direction was CDSs to bonds for Greece; bonds to CDSs for Italy and France; and Portugal and Ireland exhibits causality in both directions.

Coudert and Gex (2013)	
Period	January 2007-March 2010
Purpose of Study	Examines the interaction between the CDS and bond market.
Data Set	Uses daily data: generic 5-year CDS premia and matching bond spreads for 18 countries (11 European and 7 emerging countries). ¹¹
Main Findings	Finds bond market tends to lead sovereign CDS market in line with huge size of government debt market compared with CDS market. Results are more mitigated for high-yield countries however.

⁹ Authors use VECM analysis and Granger causality tests.

¹⁰ O’Kane uses the Granger causality measure as he found that cointegration was ruled out for all countries aside from France and Spain.

¹¹ Authors use the VECM measure however they investigated short-term interactions using Granger causality but cointegration can lead to spurious results when Granger causality is used.

Arce, Mayordomo and Peña (2013)	
Period	January 2004-February 2012
Purpose of Study	Examines which market leads the credit risk price discovery process.
Data Set	Daily 5-year sovereign bond yields and CDS spreads for 11 European Monetary Union ('EMU') countries. ¹²
Main Findings	Analysis reveals that price discovery is 'state dependent' (broadly this means that different market conditions and factors affect it). For instance levels of counterparty risk affect the ability of the CDS market to lead the price discovery process, whereas funding costs (that affect bond buyers more than CDS buyers) worsens the efficiency of the bond market. ¹³ The findings suggests that CDS markets lead price discovery in most euro areas in normal times but during times of acute stress in the Eurozone the bond market leads the price discovery process. ¹⁴

BIS (2013)	
Period	October 2008-May 2011
Purpose of Study	Examines which market is most important in terms of price discovery of sovereign credit risk.
Data Set	Intraday quotes for PIIGs, France and Germany. As the number of transactions of sovereign bonds is largely insufficient to conduct meaningful intraday analysis, the authors use the trading book or 'best proposal' quotes from the respective domestic markets. They also use 5 and 10-year USD denominated sovereign CDS quotes. ¹⁵
Main Findings	Find that CDS prices tend to move first in response to news and that bond prices tend to adjust towards pricing in the CDS market. ¹⁶

¹² Authors extends the VECM analysis over time using 'rolling windows' (of 1000 days).

¹³ They also suggested that other factors impaired the ability of the CDS market to lead the price discovery process. Factors included the common volatility in the EMU equity markets (the authors suggested that information in bond spreads may be more reliable at such times), and banks' agreements to accept losses on their holdings of Greek bonds without activating CDS contracts (they suggested this meant there was a lack of confidence in the CDS markets after such agreements). Factors affecting the ability of the bond market to lead the price discovery process included investors' flight to safety to the safest financial assets (they suggested this could diminish the demand of most EMU countries' debt), and ECB intervention in the bond markets (the authors suggested that if its demand for debt is insensitive to price, the information embedded in prices formed could reveal less about the fundamental value of the bonds).

¹⁴ Notably the authors find that the degree of liquidity in the CDS market relative to the bond market does not affect the price discovery process (in contrast to e.g. Ammer and Cai). They attribute this finding to the special features of the period (i.e. a period of financial stress and limited access to funding). The authors suggest that at such times a major determinant of the degree of investors' participation in the bond market will be the availability and cost of funding rather than the size of the bid-ask spread. Also the relative importance of the bid-ask spread could be of secondary importance when big players such as the ECB are buying bonds without regard to it.

¹⁵ Authors use a VECM approach.

¹⁶ Authors observed their findings could not directly be used to address the extent higher CDS spreads were likely to result in higher bond market credit spreads and lower bond prices than would be warranted by fundamentals.

IMF (2013)	
Period	March 2009-September 2012
Purpose of Study	Within a broader study, the IMF examines which market leads the price discovery process. ¹⁷
Data Set	Examines 33 countries (advanced and emerging market economies). Statistics were estimated at the country level. ¹⁸
Main Findings	Informational value of CDSs has become more important but varies widely over countries and time. Finds that sovereign CDSs incorporate information faster as CDS liquidity increases and that sovereign CDSs tend to reveal information quicker in advanced economies during times of stress.

¹⁷ The IMF also examines sovereign CDS spreads and suggests they reflect the same economical fundamentals and other factors (including market microstructure factors (i.e. bid-ask spreads) as the underlying bonds. The IMF observed that sovereign CDSs provided a good hedge to offset sovereign credit risk, thereby enhancing financial stability.

¹⁸ Uses the Hasbrouck statistic using the VECM method.

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