Regulating Short Selling in Europe After the Crisis

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Abstract

Short selling contributes to the efficient functioning of capital markets. While bullish investors tend to hold long positions, bearish investors act on information by shorting stock, therefore fostering the incorporation of good and bad information into stock prices. Yet short sellers are ill viewed by corporate officers and directors and financial regulators. In the midst of the 2008 global financial crisis, several financial regulators in the European Union issued emergency orders to crack down on short sellers, which resulted in a fragmented approach to short selling and created a case for regulatory action at the European Union level. This article reviews the European Commission’s proposal on short selling and certain aspects of credit default swaps, adopted on September 15, 2010. While the need to shed light on this trading strategy further supports the need for regulatory action, there appears to be some cause for concern. This article evaluates the European Commission’s approach and finds reasons to believe that it is unduly tilting the playing field against short selling and undermining the efficiency of capital markets in the European Union.

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Introduction

Short selling has always drawn the attention of regulators, particularly in the European Union (the “EU”). The first regulation on short selling was enacted in Holland in 1610. One year before in 1609, Isaac Le Maire, a Dutch businessman, founded a secret association – “Groote Company” – in order to short the shares of the Dutch East India Company, in anticipation of the incorporation of a new rival French company,\(^1\) sending the company’s price into a plunge. Only eight years after the founding of the Amsterdam Stock Exchange, Dutch authorities outlawed all short sales.

Every crisis has unleashed political disdain about short sellers and prompted regulators to introduce curbs or outright bans on short selling. In 1932, Hoover, then President of the United States (the “U.S.”), required an inquiry into short selling and expressed fears that “destructive short sellers” were “preventing an economic rebound.”\(^2\) In 1997, *Crédit Lyonnais*, a French bank, was blamed for short selling after the collapse of Malaysia’s stock market and currency.\(^3\) In the aftermath of the 2008 global financial crisis (the “Crisis”), critics are no different and regulating short selling, which represents roughly 1-3 percent of market capitalization in Europe,\(^4\) remains a stormy debate and a controversial issue.

(i) The EU Approach to Short Selling During the Crisis. At the height of the Crisis in September 2008, after the rescue of Bear Stearns and the bankruptcy of Lehman Brothers, regulators in several EU countries (the “Member States”) issued temporary emergency orders, as they grappled how to deal with the Crisis. Indeed, they decided to crack down on bearish short sellers, which resulted in a fragmented approach to short selling across the EU between 2008 and 2009,\(^5\) torn between bans on the short selling of financial stocks (Austria, Belgium, France, Germany, Italy, Luxembourg and Portugal), bans on the short selling of all listed stocks (Italy and the Netherlands), bans on the naked short selling of financial stocks (Denmark, Ireland, Italy, the Netherlands, Norway and the United Kingdom (the “UK”), bans on the naked short selling of all listed stocks (Austria, Greece and Italy), disclosure of net short positions in financial stocks (Belgium, Greece and Italy),


\(^3\) Daniel Trotta, *Short Sellers Have Been The Villain For 400 Years*, REUTERS, Sept. 26, 2008.


France, Germany, Ireland, Portugal, Spain and the UK) and disclosure of net short positions in all listed stocks (Greece, Hungary and Spain).

The approach to short selling was also chaotic within some Member States, which added a sense of uncertainty to the Crisis that was roiling in the financial markets. In particular, Italy successively banned (i) naked short sales of financial stocks from September 23, 2008 to September 30, 2008, (ii) short sales of financial stocks from October 1, 2008 to October 9, 2008, (iii) short sales of all stocks from October 10, 2008 to December 31, 2008, (iv) short sales of financial stocks and stocks of companies increasing their outstanding share capital from January 1, 2009 to January 31, 2009, (v) naked short sales of all stocks from January 1, 2009 to July 31, 2009, (vi) short sales of financial stocks and stocks of companies increasing their outstanding share capital from February 1, 2009 to May 31, 2009 and (vii) short sales of stocks of companies increasing their outstanding share capital from June 1, 2009 to July 31, 2009. 6

Moreover, these temporary emergency orders might well have been illegal in some Member States. Particularly, Bonneau argued that the French Autorité des Marchés Financiers (the “AMF”) had no legal authority to ban short selling activity during the crisis. 7 Lawyers think that issues of legal authority do matter, even in the midst of a severe global financial crisis, and such a dismissive attitude therefore raised some concern.

(ii) The EU Regulatory Approach in the Aftermath of the Crisis. On September 15, 2010, the European Commission adopted the Proposal for a Regulation on Short Selling and Certain Aspects of Credit Default Swaps (the “Proposal”). 8 This Proposal is aimed at harmonizing the rules applicable to short selling across the EU and clarifying the powers of competent regulators. To that purpose, the European Commission is using a “regulation”, which is binding in its entirety and directly applicable in all Member States, as opposed to a “directive”, which is only binding as to the result to be achieved and leaves to the national authorities the choice of form and methods. 9 The Proposal will therefore be enforceable throughout the EU without the need for further legal thinking by any Member State. However, cooperation between the European Commission and Member States remains a crucial issue since the Proposal has to be approved by both the European Parliament and the Council to become effective under the ordinary legislative co-decision procedure. This legislative process is highly complex and, while the

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6 The ban has been extended sine die on August 1, 2009. See CONSOB Resolution No. 16971 (July 28, 2009), available at http://www.consob.it/mainen/documenti/english/resolutions/res16971.htm.


9 Treaty on the Functioning of the European Union art. 288.
European finance ministers appeared to have reached a deadlock over the Proposal,\(^\text{10}\) the Committee on Economic and Monetary Affairs of the European Parliament has recently amended the Proposal (“Report of the European Parliament”).\(^\text{11}\) Still, the recent bans adopted by Germany and Greece and the decision by the French AMF to bring a new level of transparency to net short positions\(^\text{12}\) sowed confusion further and confirmed the need for a specific legislative framework at the EU level to deal consistently and effectively with short selling.

In contrast, the U.S. Congress (the “Congress”) did not address the issue of short selling in a specific law or regulation nor designed a ready-to-use set of rules in the aftermath of the Crisis. Instead, the U.S. Securities and Exchange Commission (the “SEC”) was given broad authority to regulate further short sale transactions by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law by President Obama on July 21, 2010. Particularly, Section 929X gives the SEC the authority to, *inter alia*, design new disclosure requirements and rules necessary or appropriate to ensure that the appropriate enforcement options and remedies are available against manipulative short selling. When relevant, this paper will compare the EU and U.S. approaches.

\(\text{(iii) The Mechanics of Short Selling.}\) Short selling is commonly defined as the practice of selling a security the seller does not own at the time of the sale. A short seller can sell a security she does not own using the securities lending market. Two different strategies might be followed. In a covered short sale, the seller borrows or makes arrangements to borrow the security prior to the short sale. On the other hand, in an uncovered or naked short sale, the seller neither borrows nor makes arrangements to borrow prior to the short sale but still will borrow and deliver the security to the buyer by the settlement date, usually three business days after the trade date. In both strategies, the short seller will close out the position by repurchasing and returning the same security to the lender.

The definition laid out in the Proposal does not represent a departure from this widely accepted definition. Under article 2(1)(p) of the Proposal a “short sale in relation to a share or debt means any sale of the share or debt which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt for delivery at settlement.” Likewise, Rule 200(a) of Regulation SHO, which sets


\(^{12}\) Article 223-37 of the French AMF General Regulation requires the notification to the AMF of any net short position that becomes equal or greater than 0.2, 0.3 or 0.4 percent of the capital of a company whose shares are admitted to trading on a regulated market or traded on an organized multilateral trading facility. Moreover, any short position that becomes equal or greater than 0.5 percent must be publicly disclosed, as well as any increments of 0.1 percent.
forth the U.S. regulatory framework governing short sales, refers to “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.”

A short seller makes a profit ($\Pi$) if she sells the borrowed security for a price ($S$) higher than what she pays to return the security to the lender ($R$): $\Pi = S - R$, as shown by the downward sloping curve in the figure below.

\[ \begin{align*}
\Pi_{\text{max}} &= S \\
\text{Profit } \Pi (\$) &= S - R \\
\text{(Loss) } \Pi (\$) &= R - S \\
\text{Share Price } (\$) &= R \\
\text{Short Sellers’ Payoff Profile} \\
\end{align*} \]

The downward sloping curve makes it clear that short sellers expect stock prices to decline. Consider short selling a security for $S$. The short seller will make a profit if she pays less than $S$ to return the security to the lender, e.g. $R'$ but suffer a loss if she pays more than $S$ to return the security to the lender, e.g. $R''$. A short seller usually bears indirect costs ($C$) such as lending fees paid to the securities lender. As a consequence, a short seller must be able to cover these costs in order to earn a profit, i.e. to pay less than $S'$ to return the borrowed security. Here, $\Pi = S' - R$, with $S' = S - C$.

Short selling is highly risky. The outcome of such trading strategy relies on stock price evolution and short sellers have limited upside potential profit but no downside protection. While the potential profit is capped at $S$ (or $S'$), the potential loss is unlimited. Here is why short selling is much more risky than similar bearish strategies using put options, where both profits and losses are capped.

(iv) Short Selling and Market Efficiency. Short sellers are usually considered to be greedy speculators reaping the benefits of bearish financial markets at the expense of the general welfare. In particular, corporate officers and directors are hostile to short sellers. “I will hurt the shorts, and that is my goal.”

\[\text{13 Andrew R. Sorkin, Lehman Brothers takes on rumors by ‘the shorts’, N.Y. TIMES, July 8, 2008.}\]
then CEO of Lehman Brothers, a few months before the collapse of the broker-dealer, gives an accurate sense of how ill viewed short sellers are in the corporate community. Indeed, short selling conveys bad information to the markets about a particular security, worries long investors and therefore puts corporate officers and directors in the hot seat. Corporations are often prone to blame short sellers for their financial woes rather than to admit management’s flaws. Lamont studied the methods used by firms to impede short selling and prop up their stock price. These methods include belligerent statements claiming that “short sellers are acting improperly to cause the stock price to go down,” soliciting legal actions from regulatory authorities and disrupting the securities lending markets to prevent would-be short sellers from borrowing stocks. 14 Is short selling really a disruptive trading strategy hurting the formation of market stock prices? Not necessarily.

Academic literature provides strong evidence showing that short selling contributes to the efficiency of financial markets. Following Fama’s insight, a market is efficient when prices “fully reflect available information.” 15 Three different forms of market efficiency might be considered, depending on the types of information that is expected to be incorporated into stock prices: a “weak” form where a security’s price reflects all information conveyed by past prices; a “semi-strong” form where a security’s price reflects all publicly available information; a “strong” form where a security’s price reflects all available information, either public or private. Gilson and Kraakman explain that markets cannot be efficient in the “strong” form because the costs of acquiring private, non-public information are too high. 16 On the other hand, mandatory disclosure rules make information about an issuer available to investors at a very low cost. Investors act on information 17 and a security’s price therefore reflects such publicly available information, strengthening the efficiency of financial markets in the semi-strong form.

There are also two aspects of market efficiency. Informational efficiency describes how fast the information is incorporated into market prices while allocational efficiency describes the best allocation of resources in the market. 18

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17 Ray Ball, The Global Financial Crisis and the Efficient Market Hypothesis: What Have We Learned, 2009, J. APPLIED CORP. FIN., Fall 2009, 8, 10 (arguing that if investors do not act on information, the market would no longer be efficient. The argument that no one should act on information “confuses a statement about an equilibrium ‘after the dust settles’ and the actions required to obtain that equilibrium”).

Even though all investors are disclosed the very same information through mandatory disclosure rules, investors have heterogeneous beliefs. While long investors can be seen as optimistic (they expect the price of a security to soar), short sellers can be deemed pessimistic (they expect the price of a security to fall). Following Miller’s intuition, when investors disagree about the value of a security, any constraints on informed bearish short sellers lead to overpriced securities. Without short sellers acting on bad information, a security’s price does not fully reflect available information and financial markets can no longer be deemed efficient. Therefore, promoting short selling is a way to promote market efficiency. Moreover, most of the research also suggests that short sales ensure a smooth functioning of financial markets. Particularly, short sellers create liquidity when they sell, borrow and repurchase securities on the market. Market makers also use short selling to fill clients’ orders with respect to securities that are not immediately available and thus provide liquidity to the market. Short selling is also a commonly used hedging strategy that insures the rest of a given portfolio against a decline in stock prices. Finally, by giving the opportunity to pessimistic investors to act on information, short selling mitigates the formation of market bubbles.

(v) The Case for Regulatory Action. Against this background, what is the rationale for government intervention? Why should short selling be regulated in the first place? There is no evidence short sellers did cause the Crisis or Lehman Brothers’ end. On the contrary, with respect to Lehman Brothers, Warren Buffet suggested that blaming short sellers was indicative of a failure to admit one’s own problem. Likewise, Thomas Baxter, Jr., General Counsel of the Federal Reserve Bank of New York, saw good cause in shorting Lehman and Richard Posner has argued that “there was not enough short selling to alert the market and the [U.S.] government to the weakness of the banks, in part because (...) short selling is a risky investment strategy.” However, the Crisis revealed at least one market failure that has to be fixed at the EU level: market participants did not take the appropriate steps to shed light on short selling. Opaquelessness was a deep enemy during the Crisis and prompted many regulators to intervene in their own jurisdiction. Regulating short selling at the EU level should harmonize the current fragmented approach without jeopardizing market efficiency. EU authorities should therefore shed light on short selling without discouraging short sellers or allowing interference with market allocation of resources.

Against this background, we can now examine the Proposal’s approach. The Proposal takes a tough stance on short selling, arguing that it “could aggravate the downward spiral in the prices of shares, notably in financial institutions, in a way which


21 *Id.* at 665.

could ultimately threaten their viability and create systemic risks.” More than 400 years after the Dutch authorities outlawed short selling, EU lawmakers are still wary of short sellers. What it means for the efficiency of financial markets within the EU is uncertain but there appears to be some cause for concern.

I. Enhanced Transparency Rules

The Proposal suggests promoting transparency of short selling using two different sets of rules: a two-tier disclosure regime of net short positions (A) and a marking regime of short orders (B).

A. Two-Tier Disclosure Regime of Net Short Positions

For companies whose shares are admitted to trading on a trading venue, i.e. a regulated market or a multilateral trading facility in the EU, the Proposal provides for a two-tier model for transparency of net short positions relying on private notifications to the regulator and disclosures to the public. In comparison, since the expiration of “Form SH Order” on August 1, 2009, the SEC is relying on several Self-Regulatory Organizations (“SROs”) to increase transparency surrounding short selling activity. SROs are providing website disclosures with respect to daily aggregate short selling volume in each individual security and anonymised information regarding individual short sales transactions on a one-month delayed basis. The appointed SROs are BATS Exchange, Direct Edge Holdings, FINRA, International Securities Exchange, NASDAQ Stock Market, NASDAQ OMX BX, National Stock Exchange, New York Stock Exchange, NYSE Amex and NYSE Arca. The SEC also discloses twice monthly the aggregate net balance of shares that failed to be delivered as of a particular settlement date. These fails-to-deliver data are disclosed on the SEC website, for all equity securities.

23 The fear that short selling could create systemic risks is mentioned seven times in the Proposal.

24 Under article 4(1)(15) of the Directive 2004/39 of the European Parliament and of the Council of April 21, 2004 on Markets of Financial Instruments, “multilateral trading facility” means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provisions of Title II [of the Directive].

25 On September 18, 2008, the SEC issued an emergency order, the "Form SH Order". Form SH required institutional investment managers that exercise "investment discretion" with respect to accounts holding "section 13(f) securities" (i.e. equity securities of a class described in section 13(d)(1) of the Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association) having an aggregate value of at least $100,000,000 to file Form SH with the SEC. Form SH was filed electronically on the last business day of every week immediately following a week in which the manager effected short sales. Form SH required the disclosure of the gross number of the securities sold short during the day.

1. Prelude: What is a Net Short Position? Are There any Exemptions?

Under article 3.4 of the Proposal, a net short position is obtained by deducting any “long position” from any “short position.” Holding a share creates a long position while short selling a share creates a short position. The Proposal goes further in order to prevent traders from circumventing the law using options, futures, contract for differences (CFDs) and credit default swaps (CDS), even if such alternative strategies are usually more costly for traders. Therefore, entering into a transaction which creates or relates to a financial instrument and confers a financial advantage in the event of a decrease (or increase) in the price of the share is deemed to create a short (or long) position (article 3.2 of the Proposal). As a consequence, traders will not be able to use strategies based on the put-call parity according to which buying a put, writing a call and selling a bond yield to the same payoff as shorting a security in efficient capital markets.27 The transparency regime is also designed to cover over-the-counter short selling, as long as the net short position is created with respect to shares admitted to trading on a trading venue in the EU. Appropriately, the two-tier disclosure regime applies whether short sellers, either natural or legal persons, are residing or established with the EU or not.

Short sellers are required to quickly notify or disclose net short positions. The calculation of a net short position shall be made at 12:00 pm28 on the trading day and the notification shall be made by 3:30 pm on the next trading day (article 9.2 of the Proposal). Such a short notice requirement seems key because a lot of short positions are short term and the notification or disclosure of closed-out short positions is of little interest. In the notification or disclosure form, short sellers shall list their identity, the size of the relevant position, the targeted issuer and the date on which the relevant position was created, changed or ceased to be held (article 9.1 of the Proposal).

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28 It is difficult to know whether the European Commission means noon or midnight when using 12:00 pm. See Alternative Investment Management Association, Position Paper on the European Commission’s Proposal for a Regulation on Short Selling and certain aspects of Credit Default Swaps (Nov. 2010), 8, available at http://www.aima.org/en/knowledge_centre/regulatory-and-tax/position-papers.cfm. The Report of the European Parliament clarifies the Proposal and suggests requiring the calculation of a net short position at the end of the trading day (except for automated night trades where the reference should be one business day after the trade date).
This transparency model does not apply to shares admitted to trading on a trading venue in the EU when the principal venue for the shares, \textit{i.e.} the venue with the highest turnover, is outside the EU (article 14.1 of the Proposal).

Market making activities and primary market operations are also exempted (article 15.4 of the Proposal). Market making activities include (i) posting firm, simultaneous two way quotes of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market or (ii) as part of the usual business, fulfilling orders initiated by clients or in response to clients’ requests to trade, and hedging positions arising out of those dealings (article 15.1 of the Proposal). With respect to shares, primary market operations include entering into a short sale or having a net short position in relation to the carrying out of a stabilization scheme under a specific Commission Regulation.\textsuperscript{29} This regulation emphasizes that “stabilization transactions mainly have the effect of providing support for the price of an offering of relevant securities during a limited time period if they come under selling pressure, thus alleviating sales pressure generated by short term investors and maintaining an orderly market in the relevant securities.”\textsuperscript{30} Since short selling does not provide support for a security’s price, does this exemption really make sense? During a significant offering, when the number of relevant securities are not sufficient to satisfy all potential investors, an underwriter can, as provided in the underwriting agreement, short sell the relevant securities so that the underwriter would accept a number of purchases greater than the number of securities initially offered (overallotment facility). The underwriter is at risk if the price of the securities soars, like any short seller. However, such risk is limited because the issuer usually grants an option by which the underwriter will be able to purchase up to a certain amount of relevant securities at the offer price for a certain period of time after the offer (green shoe option). The exercise of overallotment and green shoe options are deemed “ancillary stabilization.”\textsuperscript{31} Therefore, short sales can be part of a stabilization scheme and the exemption of the Proposal makes sense.

2. \textit{Private Disclosure of Significant Net Short Positions}

Article 5 of the Proposal suggests requiring a short seller who has a net short position to notify the relevant competent authority whenever this position reaches of falls below 0.2 percent of the value of the issued share capital of the company. A short seller shall also notify every increment of 0.1 percent by which the position increases.\textsuperscript{32} The


\textsuperscript{30} \textit{Id.} at 34.

\textsuperscript{31} \textit{Id.} at 35.

\textsuperscript{32} The same requirement is applicable to net short positions in sovereign debt and credit default swaps (article 8 of the Proposal). With respect to sovereign debt and credit default swap, the initial and incremental thresholds shall be determined by the Commission in a delegated act.
relevant competent authorities, e.g. the French AMF and the German Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"), are to be officially designated by each Member State for the purpose of this regulation (article 26 of the Proposal).

This private disclosure requirement might be of great interest for regulators. It will provide regulators with adequate data to monitor short selling and bring enforcement actions under the Market Abuse Directive\(^{33}\). This notification system will also achieve the advantage of enabling regulators to compile statistics about short selling. These data will be accurate because the notification requirement covers net short positions created by trading shares not only on trading venues but also on over-the-counter markets. Moreover, disclosure of net short positions, which take into account long positions used to close out short sales, is more accurate than the disclosure of gross short positions in assessing the potential risks stemming for short sellers’ activity. The costs associated to this notification requirement could be dissuasive and limit short selling activity. However, short sellers already calculate their net short positions for the purpose of monitoring risks involved by their exposures. Even though short sellers could be required to amend their calculation methods to comply with the Proposal, marginal costs would be limited and largely outweighed by the benefits of the private disclosure regime.

3. Public Disclosure of Net Short Positions

Article 7 suggests requiring short sellers who have a net short position to publicly disclose details of the position whenever it reaches or falls below 0.5 percent of the value of the issued share capital of the company. Each 0.1 percent above that threshold shall also be disclosed to the public. This disclosure threshold is largely lower than the disclosure threshold for long position, which is set at 5 percent, both in the EU\(^{34}\) and the U.S.\(^{35}\)

Public disclosure of net short positions by short sellers will lower the information acquisition costs of other market participants. Following Gilson and Kraakman, this will strengthen market efficiency in its semi-strong form. The incorporation of information into market prices will become faster since whenever a net short position held by a short seller reaches or falls below the 0.5 percent threshold, all other market participants will receive this information the following business day and will be able to act on this information.


Still, such a requirement raises some serious concern. Since short sellers shall disclose their identity, a herdlike behavior may arise, i.e. the disclosure of well-known managers’ positions will lead other market participants to adopt the same strategy. This irrational aspect of financial markets has been well-developed in behavioral finance, as a critic of the efficient capital market hypothesis. In his seminal book, Shiller explains how “the behavior, although individually rational, produces group behavior that is, in a well-defined sense, irrational.”36 As a result, if all market participants follow the trend set by star managers, the market might no longer be efficient because the share price would not reflect the fundamental value of the company’s equity.

Furthermore, public disclosure of net short positions and identification of short sellers will facilitate retaliation by issuers, including belligerent statements, legal actions and short squeeze even when short selling is justified by the underlying financial situation of any given company. Such risks will deter short sellers from acting and undermine market efficiency. A recent study by the consulting firm Oliver Wyman, commissioned by the Alternative Investment Management Association (the “AIMA”), elaborates on these fears. The study shows that the implementation of a public disclosure regime would reduce short selling activity by approximately 20-25 percent. Markets would also experience a decrease in lendable securities. As a consequence, trading volumes would decrease by 13 percent, bid-ask spreads widen, volatility increase and the price discovery process be impaired (a security’s price would differ from its fundamental value). The report concludes that investors would invest less in markets where public disclosure is required and begin to allocate capital to markets “with more palatable regulatory framework.”37 The fear that regulation will unduly interfere with market allocation of resources materializes here.

What’s more, the information provided to the public might be difficult to grasp because it will be nearly impossible to know whether a given short position was taken based on the negative sentiment about a security’s underlying financial condition or for hedging purposes. The disclosed net short position might thus be misleading for many market participants.

An alternative solution, suggested by the AIMA38 and in the Report of the European Parliament39, would alleviate these fears without calling into question the benefit of public disclosure for market efficiency: the public disclosure of net short positions should not identify the holder of the net short position, i.e. the public disclosure


38 Alternative Investment Management Association, supra note 25 at 7.

should be made in an anonymous form. Indeed, this solution would rule out the fears of herding and retaliation.

B. Marking Regime

Article 6 of the proposal suggests requiring short sellers to mark or flag their sales executed on a trading venue as short sales. The trading venue will then disclose at least daily a summary of the volume of orders marked as short sales. In the U.S., Rule 200(g) of Regulation SHO also requires brokers or dealers to mark all sell orders of any equity security as “long”, “short”, or “short exempt”. Such a requirement raises some concern.

The benefits stemming from such requirement are limited because it does not cover over-the-counter short sales and it cannot be used to evaluate the outstanding short positions in the market or spot any large short position. The picture will be incomplete and therefore misleading. Moreover, the implementation of a marking regime will be highly costly. According to the UK Financial Services Authority (the “FSA”), the “work carried out by the FSA indicates that a flagging regime would be prohibitively expensive to introduce. The limited benefits that it would bring would not justify the very high implementation and compliance costs (which could be as high as £2m per firm according to responses to a survey we conducted in 2009).” These costs will be particularly high in the EU because only Greece has already the infrastructures required to implement a marking regime. The costs will be high for both short sellers and trading venues.

The marking regime does not withstand a sensible cost-benefit analysis. The Report of the European Parliament does not suggest extending the breadth of the requirement to short sales executed over-the-counter, but suggests confining disclosure to competent authorities. Unfortunately, these amendments do not radically change the outcome of the previously-performed cost-benefit analysis.

II. Prohibition of Uncovered or Naked Short Sales

The Proposal suggests the implementation of a “super locate” requirement, which will lead to a prohibition of uncovered or naked short selling (A). The Proposal also suggests specific buy-in procedures and fines for late settlement (B).

A. The Implementation of a “Super Locate” Requirement

Under article 12 of the Proposal, a short seller may only enter into a short sale of a share admitted to trading on a trading venue if (i) she has borrowed the share, (ii) she has entered into an agreement to borrow the share, or (iii) she has an arrangement with a third

40 Committee of European Sec. Regulators, Model for a Pan-European Short Selling Disclosure Regime (2010), 6.

41 Alternative Investment Management Association., supra note 25 at 10.

42 Committee of European Sec. Regulators, supra note 34 at 6.
party under which that third party has confirmed that the share has been located and reserved for lending.\textsuperscript{43}

This requirement is highly constraining. In the U.S., under Rule 203(b)(1) of Regulation SHO, a broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has (i) borrowed the security, or entered into a bona-fide arrangement to borrow the security, or (ii) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due, and (iii) documented compliance with this paragraph (b)(1). While the U.S. approach relies on a so-called “locate” requirement, the Proposal suggests the implementation of a “super locate” requirement because a short seller, not the broker-dealer, must at least “has an arrangement with a third party under which that third party has confirmed that the share has been located \textit{and} reserved for lending” (emphasis added). This rule is in fact designed to rule out uncovered or naked short selling, usually classified as manipulative \textit{per se} because short sellers can short sell more than 100 percent of the issued share capital of a company and dramatically increase the downward pressure on a particular security. Moreover, naked short selling increases the risk of settlement failures. However, it can be argued that the “super locate” requirement should not be implemented because concerns about naked short selling are already efficiently addressed in a less restrictive way.\textsuperscript{44} If a naked short selling is manipulative and abusive, regulators can use the Market Abuse Directive to investigate and bring enforcement actions. What’s more, the risk of settlement failures, currently “extremely low,”\textsuperscript{45} will be adequately addressed by the buy-in procedures and fines for late settlement. In sum, naked short selling does not require specific regulatory impediments.\textsuperscript{46}

\textbf{B. Buy-In Procedures and Fines for Late Settlement}

Under article 13 of the Proposal, a trading venue or the central counterparty that provides clearing services for the trading venue shall ensure that when a short seller fails to deliver the shares within four trading days after the day on which the trade takes place (six trading days in case of market marking activities) procedures are automatically triggered to buy-in the shares to ensure delivery for settlement. When the trading venue or the central counterparty is not able to buy-in the shares, then cash compensation is paid to the buyer by the trading venue or the central counterparty, based on the value of the

\textsuperscript{43} This provision is also applicable to short sales of a sovereign debt instrument.


\textsuperscript{45} Alternative Investment Management Association, \textit{supra} note 25 at 4.

\textsuperscript{46} Seraina Gruenewald, Alexander Wagner and Rolf Weber, \textit{Short Selling Regulation after the Financial Crisis – First Principles Revisited, supra} note 40 at 22 (arguing that “naked short selling is not actually a special case compared to conventional short selling in terms of its economic implications”).
shares at the time of delivery plus any losses incurred by the buyer. The short seller will reimburse the trading venue or the central counterparty.\footnote{This provision is also applicable to short sales of a sovereign debt instrument.}

These buy-in procedures are not an incentive for short sellers to recklessly engage in naked short selling because they have the obligation to make daily payments to the trading venue or settlement system for each day that the failure continue. These payments “shall be sufficiently high not to allow the seller to make a profit from the settlement failure and to act as a deterrent to natural or legal persons failing to settle” (article 13.2 of the Proposal). Moreover, a trading venue or the central counterparty will be able to prohibit a short seller from entering into further short sales until the settlement of the transaction (article 13.3 of the Proposal). The buy-in procedures and fines will efficiently deter naked short sellers from failing to deliver because they will be worse off once the trading venue or the central counterparty steps in – naked short sellers are fined and prevented from short selling.

In the U.S., close-out requirements focus on participants of a clearing agency and broker-dealers. Under Rule 204(a) and (b) of Regulation SHO, if a participant of a registered clearing agency has a fail to deliver relating to a short sale with respect to any equity securities, the participant must immediately close out the position by either borrowing or purchasing the shares before the beginning of trading hours on the first settlement day after the settlement date. Moreover, the participant and any broker-dealer from which it receives trades become subject to the so-called “pre-borrow penalty”, requiring them to first borrow or enter into an arrangement to borrow the security before accepting any short sales orders or effecting shorts sales for its own account in the security, until the fail is closed out by purchasing (not borrowing) the relevant security. Because Rule 204 applies to all equity securities, it eliminates the close-out requirement for “threshold securities”, i.e. securities that experience large and persistent fails to deliver, under Rule 203(b)(3) of Regulation SHO.

The Proposal should rule out the “super locate” requirement because relying solely on buy-in procedures and fines for late settlement would be a better alternative to prevent settlement disruption. First, the “super locate” requirement restricts all naked short sales whereas the buy-in procedures and fines discriminate by targeting only short sellers who fail to deliver. Second, the “super locate” requirement will “suck liquidity out of the market, pushing up the cost of borrowing, leading to hoarding of securities.”\footnote{Alternative Investment Management Association, supra note 25 at 4.} Every short seller, contemplating a covered or naked short sale, will suffer from this liquidity drain and escalation in borrowing costs. On the other hand, the buy-in procedures and fines are painful only for short sellers who fail to deliver. Third, even if the buy-in procedures are costly for a buyer who faces the risk to suffer from late delivery or be compensated in cash instead of being delivered the security she bought, the costs of the “super locate” requirement will be far greater for both short sellers (high borrowing costs, hoarding of security, liquidity drain) and buyers (liquidity drain).
The Report of the European Parliament suggests implementing the opposite solution. First, a short seller would have to comply with the “super locate” requirement by the end of the trading day only, “because no systemic risk is created if the borrowing arrangement is made by the end of the trading day.” 49 Naked short selling would be allowed, but only for a few hours. However, naked short selling would still be overly restricted, and the notion of “systemic risk” does not seem to be a sound justification to preserve the “super locate” requirement. Second, buy-in procedure and fines for late settlement would not be included in the scope of the Proposal. Such a solution would put the emphasis on the over inclusive “super locate” requirement and rule out the benefits of buy-in procedures and fines for late settlement with respect to settlement discipline.

III. Circuit Breaker Rules

Once circuit breaker rules are triggered by either “exceptional situations” or “significant fall in price” (A), there is some cause for concern because of a foreseeable lack of coordination (B) and a potentially disruptive impact on the efficiency of financial markets (C).

A. Triggering Events: “Exceptional Situations” and “Significant Fall in Price”

The Proposal suggests the implementation of new curbs to prevent short selling in battered stocks. In case of adverse events or developments (“exceptional situations”), which constitute a serious threat to financial stability or to market confidence, or significant fall in price, the competent authority of each Member State has far-reaching powers of intervention to require further transparency or to impose restrictions on short selling. In the European Commission’s own words, adverse events or developments include “not just financial or economic events but also for example natural disasters or terrorist acts.” 50 With respect to the significant fall in price, the Proposal suggests that a decline of 10 percent or more from the prior day’s closing price shall be deemed a significant fall in price.

In exceptional situations, the competent authority has the power to require further transparency of net short positions, in relation to a specific financial instrument or class of financial instruments (not covered by article 5 to 8 of the Proposal), reaching or falling below a notification threshold fixed by the competent authority (article 16 of the Proposal). This exceptional power will enable the competent authority to understand the extent to which derivative contracts are used in building short positions. Indeed, “financial instruments” include a wide range of derivative instruments, including options, futures, swaps and financial CFDs. 51

50 Commission Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Credit Default Swaps, supra note 8 at 15.
derivative instruments form an aggregate, used to calculate net short positions. Using article 16 of the Proposal, the competent authority will be able to accurately assess which derivative instruments are used to build a net short position.

In exceptional situations, the competent authority may also prohibit or impose conditions relating to persons entering into a short sale or other transaction that creates, or relates to, a financial instrument that confers a financial advantage on the person in the event of a decrease in the price or value of another financial instrument. Value of transactions that can be entered into might also be restricted (article 17 of the Proposal). These measures may apply to transactions concerning all financial instruments, financial instruments of a specific class or a specific financial instrument. Restrictions will be valid for an initial period not exceeding three months but will be renewable for further periods limited to three months at a time (article 20 of the Proposal).

Where the price of a financial instrument on a trading venue is experiencing significant downward price pressure, the competent authority shall consider whether it is appropriate to prohibit or restrict short sellers from engaging in short selling of the financial instrument on the trading venue or otherwise limit transactions in that financial instrument on that trading venue “in order to prevent a disorderly decline in the price of the financial instruments” (article 19 of the Proposal). This measure applies for the rest of the day and the following day.

On February 24, 2010, the SEC adopted a new circuit breaker rule (“alternative uptick rule”) that places price restrictions on short selling when a stock is experiencing significant downward price pressure. When a security’s price declines by 10 percent or more from the prior day’s closing price, Rule 201 of Regulation SHO prevents the execution or display of a short sale order of a “covered security” at a price that is less than or equal to the current national best bid. On March 13, 2011, 54 securities listed on the New York Stock Exchange (“NYSE”) and the NYSE Amex triggered the circuit breaker, dragged by a significant fall in Japan’s Nikkei Stock Average amid widespread worries about the impact of the 9.0 earthquake, the ensuing tsunami and nuclear power catastrophe. In particular, short selling was curbed in U.S. listed shares of Hitachi, Cameco Corp., Uranium Resources and Uranium Energy Corp.  

52 Rule 201 of Regulation SHO defines “covered security” to mean any “NMS stock”. Rule 600(b)(47) of Regulation NMS defines an “NMS stock” as “any NMS security other than an option.” Rule 600(b)(46) of Regulation NMS defines an “NMS security” as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.” The circuit breaker will therefore all securities, except options, traded on an exchange or over-the-counter.

B. The Foreseeable Lack of Coordination

At first glance, the Proposal seems to design an efficient supervisory framework that harmonizes and coordinates Members States’ interventions.

Before implementing or renewing any measure required to face exceptional situations or a significant fall in price, any given competent authority (the “Primary Competent Authority”) shall notify its EU counterparts and the newly created European Securities and Markets Authority (the “ESMA”) (article 22 of the Proposal). This notification shall include details about the class of instruments and transactions the measure aims at targeting as well as evidence supporting the implementation of such measure and its proposed effective date.54 Upon the reception of such notification, each EU competent authority may decide to take any measure in accordance with articles 16 to 19 within its own jurisdiction inasmuch as such measure is necessary to assist the Primary Competent Authority. EU capital markets being highly intertwined, this assistance is crucial to ensure the effectiveness of any measure contemplated by the Primary Competent Authority. However, one might worry (more on this in a moment) that other competent authorities will always succeed in finding a colorable argument as to the “necessity” to follow the Primary Competent Authority and intervene in their own jurisdiction, even in the absence of any exceptional situation or significant fall in price, bypassing the original impediments of articles 16 to 19 of the Proposal.

The Proposal suggests entrusting the ESMA with “a facilitation and coordination role” as to measures taken by EU competent authorities. Under article 23 of the Proposal, the “ESMA shall ensure that a consistent approach is taken by competent authorities regarding measures under Section 1 [Powers of competent authorities] especially regarding when it is necessary to use powers of intervention under Section 1, the nature of measures imposed and the commencement and duration of any measures.” In particular, after receiving notification of measures to be imposed or renewed because of an “exceptional situation”, the ESMA shall within 24 hours issue an opinion, published on its website, on whether the measure or proposed measure is necessary to address this situation, i.e. the adverse events or developments constitute “a serious threat to financial stability or to market confidence in one or more Member States, whether the measure or proposed measure is appropriate and proportionate to address the threat and whether the proposed duration of the measures is justified” (article 23.2 of the Proposal). However, the thrust of ESMA’s opinions is not far-reaching. Indeed, EU competent authorities shall only comply or explain: “Where a competent authority proposes to take or takes measures contrary to an ESMA opinion under [article 23.2] or declines to take measures contrary to an ESMA opinion under that [article] it shall immediately publish on its website a notice fully explaining its reasons for doing so.” Therefore, the ESMA does not have the legal authority to prevent EU competent authorities from implementing incoherent approaches throughout the EU.

54 The notification shall be made no less than 24 hours before the intended effective date of the measure, unless exceptional situations make it impossible to give a 24-hour notice (article 22.3 of the Proposal).
On the other hand, the ESMA seems inoffensive. Particularly, whenever (i) there is a threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the EU with cross border implications and (ii) a competent authority or competent authorities have not taken measures to address the threat or measures that have been taken do not sufficiently address the threat, the ESMA can require enhanced disclosure of net short positions, prohibit or constrain short selling and prevent either natural or legal persons from entering into certain transactions relating a financial instrument (article 24.1 of the Proposal). Before taking those measures, the ESMA shall consult, when appropriate, the European Systemic Risk Board and other relevant authorities (article 24.4 of the Proposal). The ESMA shall also take into account the extent to which the measure “(a) will significantly address the threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union or significantly improve the ability of competent authorities to monitor the threat; (b) will not create a risk of regulatory arbitrage; (c) will 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.” (Article 24.3 of the Proposal).

This analysis reveals that the Proposal suggests requiring stricter constraints on the ESMA’s intervention powers than on other EU competent authorities’. This seems to be incoherent with the Proposal’s primary objective i.e., designing a consistent and harmonized approach to short selling in the EU. The Proposal is in fact giving legal authority to every EU competent authority to interfere with market mechanisms, without entrusting the ESMA with real harmonizing powers. Incoherent temporary restrictions on short selling might thrive, which is even more worrisome considering the true impact of temporary restrictions on the functioning of capital markets.

C. The Negative Consequences of Temporary Restrictions

Academic literature provides strong evidence suggesting that short selling is not responsible for market volatility or negative market moves and that short selling constraints are highly disruptive.

In December 2008, the SEC Office of Economic Analysis issued a memorandum to Christopher Cox, then Chairman of the SEC, describing short selling activity during the first weeks of September 2008, just before the implementation of a short sale ban on financial stocks. The analysis suggests that during period of extreme negative returns “sell pressure is more intense for long trades indicating that short sales put less pressure on prices than other sales during periods of extreme negative returns.” This suggests that significant fall in price in periods of extreme negative returns might be a consequence of long investors’ actions rather than short sellers’, which undermines the rationale for government intervention.

In their study of the 2008 naked short sales restrictions in the U.S., Boulton and Braga-Alves have showed that short sale restrictions have a negative impact on liquidity as bid-ask spreads widen and trading volumes decrease. Moreover, they find no evidence that these restrictions reduce volatility. On the contrary, they find that volatility increases and conclude that market quality is affected during the restricted period.56 What we should learn from this study is clear: short sales constraints have a detrimental effect on market efficiency.

Beber and Pagano have also suggested that short selling restrictions are detrimental to liquidity, “especially for stocks with small market capitalization, high volatility and no listed options, slow the price discovery process and fail to support stock prices (except possibly for U.S. financial stocks).”

As a consequence, EU competent authorities should restrain themselves and admit that restricting short selling actually aggravates the disorderly functioning of financial markets, even in the midst of a financial crisis. The ESMA, which is required to take into account the extent to which the measure “will significantly address the threat to the orderly functioning and integrity of financial markets,” should also consider its intervention powers to be useless.

IV. Conclusion

The introduction of a fully harmonized and consistent regulation on short selling and certain aspects of credit default swaps should be encouraged in order to fix the regulatory patchwork that emerged during the Crisis. However, this paper has been critical so far because I think the Proposal will jeopardize the orderly functioning of financial markets, undermine market efficiency and promote inconsistent approaches to short selling. In particular, short selling activity will decrease, which will undermine market efficiency, because of the public disclosure regime, the marking regime and the “super locate” requirement. Moreover, EU competent authorities’ intervention powers will threaten the orderly functioning of financial markets by increasing volatility without stopping any downward pressure on any stock’s price. Bottom line, it will be business as usual for EU competent authorities, the ESMA having no legal authority to take corrective actions.

The Proposal is inappropriately tilting the playing field against short selling, even if there is no evidence that short selling was responsible for the Crisis. There is a need to shed light on short selling without threatening the integrity of financial markets. To be constructive, some rules the EU authorities might find appropriate when regulating short


selling can be listed: (i) short sellers should privately disclose their net short positions to the relevant regulators, (ii) short sellers could be required to publicly disclose their net short positions, but in an anonymous form, (iii) a marking requirement does not withstand a sensible cost-benefit analysis, (iv) a “super locate” requirement is disproportionate to address the issue of naked short selling, (v) buy-in procedures and fines are appropriate to mitigate settlement failures, (vi) legal authority matters when dealing with coordination and intervention powers and (viii) EU competent authorities should restrain themselves and not prohibit short selling, even temporarily.

These eight rules are key to promote EU’s competitiveness, an objective regulators should always keep in mind.