CESR's Call for Evidence (CESR/08-1010) concerning the Regulation of Short Selling by CESR

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11 – 30 Avenue de Friedland
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Dear Sirs

Response by the European Forum of Securities Associations

This is the response of the European Forum of Securities Associations (EFSA) to CESR's call for evidence. EFSA is an EU confederation formed by the French Association of Financial Markets ('AMAFI'), the Spanish Asociación de Mercados Financieros ('AMF'), the Italian Association of Financial Intermediaries ('ASSOSIM'), the London Investment Banking Association ('LIBA') and the Swedish Securities Dealers Association ('SSDA') to jointly promote the interests of their members in Europe. The main focus of EFSA Members' activity is the wholesale securities markets.

We are pleased to have the opportunity to offer our views on the issues which have arisen as a result of the temporary measures introduced by CESR Members and to offer views on possible permanent measures which could be introduced by CESR Members. Our members have experienced differing short selling restrictions, and some have not been subject to a short selling ban per se. Thus, our members agree with CESR that there is an urgent need to coordinate CESR Members' short selling regimes. We urge that CESR lend itself to forming a harmonised network of proportionate short selling regimes which will facilitate meaningful disclosure and eliminate the complexity of the differing approaches of its members. Reducing the complexity of the disclosure regime would liberate human and financial resources for other regulatory purposes.

<u>Impact of Measures Introduced by CESR Members</u>

* CESR has already received a copy of the study undertaken by Professor Ian W. March and Norman Niemer of the Cass Business School which was commissioned by ISLA, AIMA and LIBA[1]. The study focuses on the UK market, but compares findings regarding the observed behaviour of regulated equities in the UK with its findings of the market behaviour of relevant equities in other countries (US, France, Italy and Germany) which also had imposed restrictions of different types on short selling. Importantly, the study finds no strong evidence that the measures changed

[1] http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf

the behaviour of stock returns of the relevant equities in the UK or elsewhere when compared with the returns of unregulated equities during the same time periods. The study also shows that regulated equities performed similarly to their performance before the restrictions were imposed. The regulations did not prevent market price declines, higher volatility or wider spreads. The study did not identify strong evidence of a systematic impact of the restrictions imposed.

* In France, there is no evidence that the measures taken in September by the French Regulator (AMF) have had a positive impact on the market price of the equities governed by the short selling ban. The prices of the five financial shares subject to the ban from 22 September to 31 December declined in a range between 31.55% to 68.72% while the CAC 40 declined by 23.86%.

* In the UK, we note that the FSA has not identified publicly any evidence that short selling was being used to manipulate markets which would constitute market abuse. The prevention/detection of such activity was an important motivation for the UK short selling ban and disclosure regime governing financial shares, and the regulations were introduced under the market abuse regime, even though the FSA had clearly stated its position that short selling is a legitimate and important market activity. We are not aware of any finding of market manipulation through short selling of relevant shares in other EU Member States during the crisis period.

* The study commissioned by the LSE[2] to analyze the effect of short-selling restrictions on liquidity of affected shares traded on the LSE showed that average spreads increased more in the affected stocks by a factor of 150%, that trading volumes dropped by 10% in affected shares as compared to a volume rise of 50% in unaffected shares, that deterioration in depth for affected shares was 37% greater than for unaffected stocks, and that turnover declined by 21% in affected shares while turnover rose 42% in unaffected shares. Lastly, affected shares appeared to have lower liquidity during the short selling ban than did unaffected shares

* The varying short selling restrictions imposed by CESR members created very challenging conditions for non-European firms to comply fully with the differing rules. Further, compliance with MiFID and best-execution requirements in particular was made more challenging, since traders had to be made aware of differing trading regulations across the EU. Matters were made especially difficult because there was no time for proper systems development. Each firm had to expend significant human and financial resources to understand and keep track of relevant regulations in the various member states which mocks the single market paradigm.

* A reasonable conclusion seems to be that the restrictions on short selling which have been imposed by various Members of CESR have apparently restricted legitimate market activity without achieving measurable market advantages. For example, the restrictions in the UK may have had some detrimental effects. However, we are aware that the FSA has compiled its own analysis which will shed further light on the efficacy of the restrictive measures in question.

* We do appreciate that the measures introduced by CESR Members were emergency temporary measures deemed necessary in a time of financial crisis, and we accept that regulators should have the powers necessary to act in perceived emergencies and that extended consultations in such circumstances may not be practical.

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[2] http://www.londonstockexchange.com/NR/exeres/4473E7A5-F022-44F1-8E1A-CB1592BF5B55.htm

* On the other hand, our view is that it is now possible to formulate meaningful principles to govern the exercise of emergency powers in general and with respect to short selling in particular. Such principles would serve to assist a more proportionate and coordinated EU approach to emergent situations.

Possible Permanent Measures by CESR Members

* It is necessary for CESR Members to articulate a consensus view on short selling as a legitimate and important market activity which is an essential part of price formation. Many academic studies and regulators take that view.

* On this subject we can note the study written by Professor David Thesmar published by BNP Paribas Hedge Fund Centre at HEC[3],

* Also, on 19 September 2008 the US Securities and Exchange Commission indicated that "Under normal market conditions, short selling contributes to price efficiency and adds liquidity to the markets. At present, it appears that unbridled short selling is contributing to the recent, sudden price declines in the securities of financial institutions unrelated to true price valuation".[4]

* It follows from this that any regulation of short selling should be to ensure orderly and fair markets as opposed to preventing market abuse which is adequately addressed by the Market Abuse Directive and its progeny.

* Our members are opposed to a general ban on short selling which can have deleterious effects on the market Short selling is a legitimate and important trading activity which is vital for price discovery.

* Banning "naked" short selling – where short selling is defined as selling with no intention of making timely delivery - is in theory appropriate; but in practice it will be very difficult to discern the sellers' intention at the point of the sale transaction. Requiring a short seller to arrange a loan of securities before making a short sale will practically impair the timing of the sale. On balance, any naked short selling ban seems impractical.

* Naked short selling becomes apparent at settlement date. We suggest that effective regulation could consist of appropriate clearing, settlement, and buy-in procedures which could be augmented with appropriate disclosure provisions

* Public disclosure of short interests in securities by individual or other investors will not be particularly helpful to the market or other investors although it may be helpful to regulators in certain cases. On the other hand, public notice of the aggregate net short interest in a particular equity at reasonable intervals would be of considerable interest to the market and other investors. The difficulty will be calculating the net aggregate short interest in an environment characterized by market fragmentation. At this point it is not possible to determine what the best method of providing aggregate information would be in terms of cost and complexity or whether the costs benefit analysis would justify implementation. It might be that tagging short sales (and cover short purchases) would enable a regulator or settlement system to compile an aggregate number for public use, but this would entail capture of the

[3] http://www.hec.fr/professeurs_recherche/hfcentre/documents/EN_HEC%20Newsletter%201.pdf

[4] http://www.sec.gov./news/press/2008/2008-211.htm

sellers' instructions at the time of the transaction or settlement instructions. Alternatively, the regulator could aggregate the net short disclosures of individuals and other investors on a periodic basis which could capture the aggregate of significant net short positions (as defined).

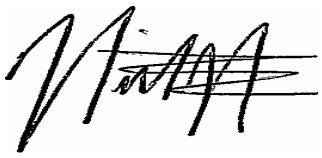
* If any disclosure regime is deemed necessary, it should exempt the short selling transactions and aggregate short positions of market makers including hedging activities in order to avoid exacerbating the risks faced by market makers in providing liquidity in the markets. Disclosure of short positions would expose market makers to increased trading risk by tipping their positions to market counterparties and institutional traders.

* This practical need is recognised in the Transparency Directive which exempts from the disclosure requirement significant share holdings (long) of market makers up to 10% of outstanding shares as well as allowing Member States to exempt proprietary trading positions of up to 5% of outstanding shares.

* It would be equally important to exclude from any disclosure regime the bona fide hedging activities of regulated members of underwriting syndicates and sub-underwriting groups who may wish to sell shares equivalent to their commitments in order to adjust their risk posture. These activities reduce the cost of capital by reducing the risks undertaken by underwriters and sub-underwriters. The proposed exclusion would not extend to short sales beyond the firm's commitments as underwriter or sub-underwriter. Sales offsetting underwriting commitments need not be viewed as short sales, since the short may be offset against shares received to fulfil an underwriting commitment. It is worth noting that until now, underwriters and sub-underwriters have been allowed to hedge without disclosure. A change from that practice may reduce the amount of capital available for underwriting and sub-underwriting.

* It is most important that CESR members arrive at a regulatory structure for short selling that is both proportionate and broadly applied throughout the EU. The costs and complexity of differing regimes among Member States are quite pronounced. The complexity leads to lack of clarity and a less accurate disclosure result. Our member firms have indicated that the systems development for disclosures is inordinately challenged by the need to accommodate differing regimes.

Yours sincerely



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On behalf of the European Forum of Securities Associations (AMAFI, AMF, ASSOSIM, LIBA, and SSDA)