

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Mr. Carlo Comporti
Mr. Michael Treip
Committee of European
Securities Regulators (CESR)
11-13 Avenue de Friedland
75008 PARIS
FRANCE

10178 Berlin, den 20. Januar 2009
Burgstraße 28
AZ ZKA: 413 - EU
AZ BdB: K 25 - Kn

CESR's Call for Evidence "Regulation of Short Selling by CESR Members"
here: Comments of the Zentraler Kreditausschuss (ZKA)

Dear Mr. Comporti, dear Mr. Treip,

Please find enclosed our comments on the CESR Call for Evidence regarding the regulation of short selling. We are grateful for the opportunity to comment on this important issue which has given rise to some controversy over the last couple of months.

Yours sincerely,
for the Zentraler Kreditausschuss
Bundesverband deutscher Banken



Georg Baur



Felix Koehn

Enclosure

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Comments of the Zentraler Kreditausschuss¹ on CESR's Call for Evidence “Regulation of Short Selling by CESR Members”

Ref.: CESR/ 08-1010

20 January 2009

¹ The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.

We appreciate the opportunity to comment on the call for evidence tabled by the Committee of European Securities Regulators (CESR) concerning future principles for the regulation of short selling. We welcome the efforts of the CESR task force to facilitate convergence of the measures to be taken by national regulators. The goal should be to establish a common European approach to the regulation of short sales while minimising the adverse implications for the efficient functioning of the markets. We consider this objective extremely important since the extensively integrated European financial markets require a consistent regulatory framework. Many financial institutions operate across a multiplicity of different countries and monitoring differing rules in many jurisdictions is complicated and highly inefficient.

Benefits of short selling and permissible activities

Contribution to the efficiency of the financial markets

The key argument in favour of short selling is its contribution to the efficient functioning of the financial markets. This positive impact is largely undisputed and has been widely confirmed by a number of academic studies². Although their findings are based on research undertaken before the financial crisis, we still consider them to be fundamentally valid. The ability to sell short enhances information efficiency so that information about the affected company is reflected more rapidly in the price of its shares. Short sales can thus help to correct excessive price increases and the formation of bubbles. They also play a role in facilitating market liquidity since the associated sell and buy transactions increase supply and demand respectively. This basic argument of greater market efficiency applies to covered as well as to naked short sales.

Risk management

Another major benefit of short selling is its contribution to efficient risk management. In recent years especially, futures and options products have proved to be valuable instruments offering extensive, scalable protection against downside risks. The providers of these products rely on short sales to a certain extent to hedge their own positions. Any restrictions or bans on short selling would therefore increase the cost of risk management for financial and non-financial firms.

² See for example:
Bris, A./ Goetzmann, W./ Zhu, N. (2007): Efficiency and the Bear: Short Sales and Markets Around the World, The Journal of Finance, Vol. 62, Issue 3, pp. 1029 - 1079.
Charoenrook, A./ Daouk, H. (2005): A Study of Market-Wide Short-Selling Restrictions, working paper, Vanderbilt University und Cornell University.
Saffi, P./ Sigurdsson, K. (2007): Price Efficiency and Short Selling, AFA 2008 New Orleans Meetings Paper.

Share placements

The ability to sell short is also beneficial to certain types of share placements. Take, for example, recapitalisations by German listed joint stock companies through rights issues, which can usually be traded on an exchange. Shareholders can sell their subscription rights or buy additional rights. Normally, one of the underwriting banks (the so-called coordinator of the rights trading) will set prices during the subscription period because subscription rights usually trade at very low volumes and so prices can otherwise become highly volatile. This practice is intended to ensure that rights trading takes place in an orderly manner. If the underwriting bank buys subscription rights during this price-making process, it will usually sell some existing shares to hedge against building up an excessively large position of its own in these shares (and/or subscription rights). The hedging mechanism can also take the form of a short sale. This is the only way for issuing banks to support the rights trading in an economically viable manner. Rights trading makes an important contribution to the success of a rights issue and consequently plays a major role in raising equity capital, especially in economically difficult situations.

Convertible or exchangeable bonds

Short sales play a key role, too, in the trading of convertible or exchangeable bonds. Hedge funds, for example, normally use short sales to hedge the risk of a fall in the value of the shares underlying a convertible bond. For investors of this kind, the ability to sell short is sometimes even a prerequisite for acquiring convertible bonds. Hedge funds, in their capacity as investors, have become increasingly important in recent years to the marketability of equity-linked products. It is therefore also in the interests of issuers to take account of their needs.

Naked short sales

The benefits of short selling outlined above are considerable and the drawbacks associated with a general ban would clearly not be acceptable. The question then arises as to whether a ban on naked short sales would be justifiable. In our view, this is extremely doubtful since the basic argument of greater market efficiency, in particular, applies not only to covered but also to naked short sales.

We would like to point out in this context that naked short sales do not cover transactions on futures and options exchanges (especially short futures). This is also the view of the German financial regulator BaFin. But where true naked short selling is concerned, it is argued that the lack of cover theoretically enables sellers to sell more shares than are actually in circulation and use the high volume of sales to push down the price of the affected stock. The temporary restrictions on short selling introduced in response to the financial crisis were intended to

prevent this and help to stabilise the markets. Initial academic studies on the impact of these measures suggest, however, that the adverse influence of short selling was strongly overestimated and that the ban has consequently failed to have the desired stabilising effect³. There is no evidence that the prices of affected shares behaved substantially differently before and after the introduction of the ban or behaved differently from shares which were not affected by the restrictions. These findings offer no basis for a long-term ban on either covered or uncovered short selling since measures of this kind do not seem capable of reducing volatility or significantly slowing a decline in prices. The studies show that, in the US, intraday volatility and bid-ask spreads have actually increased, thus making the overall market situation even worse.

Market abuse

The fact that short selling plays a role in certain types of market abuse (e.g. short and distort) is no justification for banning the practice either. Short sales are simply used as a tool in such cases and are not damaging per se. Statutory arrangements are already in place to combat abusive behaviour. Systematic manipulation of a share price, together with the dissemination of misleading information which may accompany it, is illegal and punishable as market abuse.

Exemptions

In conclusion, we would like to reiterate that, for the reasons mentioned above, we see no legitimate reason for a ban on short selling. This includes naked short selling. If, however, restrictions of any kind are to be introduced, it needs to be ensured that there are exemptions for certain concrete activities that are of great importance to the efficient functioning of the financial markets and that rely on short selling for effective execution. These are:

- o open transactions subject to the designation of the counterparty (*Aufgabegeschäfte*),
- o market making transactions,
- o sales triggered by fixed-price transactions on behalf of clients,
- o short sales by issuers necessitated for hedging purposes,
- o special features of transactions in convertible/exchangeable bonds.

³ For an analysis of six different markets, including UK, USA and Germany, see: Marsh, I. W./ Niemer, N. (2008): The Impact of Short Sales Restrictions.
For an analysis focusing on the US-market see:
Bris, A. (2008): Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order.
Bris, A. (2008): Shorting Financial Stocks Should Resume, The Wall Street Journal, 29 September.

Appropriate controls to regulate permissible short selling

Clearing and settlement rules

Another argument against an outright ban on naked short selling is the experience of the German market, which in any event has had no problems with this practice to date. Even the temporary ban on the naked short sales of certain financial instruments is described by BaFin as merely a “preventative” measure. The reason why naked short selling does not play a greater role in Germany lies essentially in the rules governing the clearing and settlement of securities. First, Germany has an extremely short maximum settlement period of t+2 and, second, market participants face sanctions by the CCP or their counterparty if this period is exceeded (CCP close-out requirements or the purchase of the securities by the counterparty at the expense of the short seller).

For this reason, naked short sales are limited in Germany to a relatively short, two-day window, in which sellers have to acquire shares to cover their position if they are to avoid sanctions. We believe that the international introduction of appropriate and short maximum settlement periods, coupled with the enforcement of penalties in the event of their being exceeded (close-out requirements or the purchase of securities by the counterparty at the short-seller’s expense), would be more effective than an outright ban on short selling.

Pre-borrowing requirements

Pre-borrowing requirements would be tantamount to a ban on naked short sales. We do not agree with such a step for the reasons explained above.

Tick rule

The US had a tick rule⁴, which was introduced in 1938 and withdrawn in 2007. The decision to drop the rule was taken in light of the findings of a pilot study, which showed that the tick rule was not necessary to prevent market manipulation and, in addition, had a slightly adverse effect on liquidity. For these reasons, we do not believe it would be useful to introduce such a restriction on short selling.

Restricting short selling during rights issues

In 2008, short selling came under the spotlight in the UK in connection with falling prices during rights issues. Several banks saw their share price drop considerably while trying to raise new capital. This called into question – at least temporarily – the ability for their issues to be

⁴ Under the US tick rule, a short sale was only permitted if the last price of the security was higher than the last price but one or if the last price remained the same but was higher than the last different price.

placed. The November 2008 report by the Rights Issue Review Group⁵, however, found that short selling was at most one of several reasons for the difficulties experienced. Among the main reasons identified by the report were a generally difficult market environment for share issues (especially in the banking sector) and, above all, the lengthy 21-day subscription period, which is much longer than that in Germany. With respect to short selling, the review group pointed out that the FSA was planning consultations in 2009. Problems of this kind have not been experienced in Germany up to now. On the contrary: as explained above, short selling can also prove extremely beneficial to share issues (see our comments on share placements).

Disclosure and reporting of short sales

As a general point, it is important in any discussion of this issue to make a distinction between reporting short sales to the competent authorities and disclosure to the market.

The more detailed and prompt the disclosure of short sales to other market participants, the more likely it is that such a disclosure will have an adverse effect. First, there is a risk of a cornering of short sellers at the time of repurchase and, second, the short sales may be seen as an indication of falling prices, thus putting unnecessary pressure on the security. For these reasons, we reject the introduction of a requirement to disclose either naked or covered shorts to the market. But we also have reservations about a requirement to report short sales to supervisors since the resulting administrative burden would not be matched by any discernible benefit. The introduction of such a requirement would therefore be disproportionate, especially if intermediaries rather than the short sellers themselves were affected.

Although we fundamentally reject the idea of reporting requirements, our comments on their possible form – should they nevertheless be introduced – are as follows:

(i) Who will do the reporting?

The question of who will do the reporting is key to the issue of proportionality. Reports by intermediaries could only be based on the information available to them.

Responsibility for supplying an overview of a particular investor's total holdings can therefore only lie with the investor himself. Since intermediaries normally only have full information about the securities they themselves hold, they have no way of ascertaining whether their clients may have holdings of the security in question in another external

⁵ "A report to the Chancellor of the Exchequer" of November 2008 by the Rights Issue Review Group, available at : http://www.hm-treasury.gov.uk/d/pbr08_rightsissue_3050.pdf

account and thus whether a transaction really constitutes a short sale or not. Reports by intermediaries may therefore paint a false picture.

Should intermediaries be required to submit reports despite the concerns outlined above, use should be made of existing systems as far as possible. A possible solution would be for the intermediary to use these to send a consolidated report to the competent authority on a daily basis.

(ii) What to report and level of detail?

We would like to reiterate that we are fundamentally opposed to reporting requirements of any kind. If reporting requirements are nevertheless introduced, these should be limited to shares. The inclusion of listed derivatives would be particularly problematic because state interference of this kind could cause major disruption in the derivatives markets.

(iii) The trigger level of reporting?

We do not believe that a specific reporting threshold would be helpful because it would offer potential for circumventing requirements, especially for the purposes of market abuse. Given that aggregating various client holdings is an extremely complex task, especially where highly fungible securities are concerned, it would make good sense to set an error tolerance threshold, however.

(iii) Report to whom?

If a reporting system is introduced, the information should be reported using channels which already exist in member states. In Germany, reports are submitted direct to the competent authorities.

(iv) What information for public disclosure and how to disseminate and frequency of disclosure?

Should information have to be disclosed to the market, it is essential for such disclosure to take place only after a time-lag and in consolidated form. The disclosure of individual transactions would have undesirable consequences due to the potential response of other market participants. First, there would be a risk of a cornering of short sellers at the time of repurchase and, second, the short sales might be seen as an indication of falling prices, thus putting unnecessary pressure on the security.

Conclusion

Against the background of the considerable benefits delivered by short selling, we are of the opinion that a general ban cannot be justified. This includes naked short sales. In our view, the more effective response to the excessive short selling activities which seem to have occurred in some countries would be to change the present clearing and settlement rules. Compulsory buy-in procedures with appropriate sanctions would be particularly helpful. As things stand, we see no need for further action beyond these measures. Many of the approaches discussed at the moment would involve considerable cost and effort without delivering a matching improvement in the security and stability of the financial markets. In our eyes, this also holds true for the establishment of reporting requirements.

A task that we consider extremely important in this context is the harmonisation of the differing approaches to short selling taken to date by regulators across Europe. An integrated European financial market with intermediaries operating in many different jurisdictions needs a consistent set of rules.