

CESR's call for evidence "Regulation of short Selling by CESR members" (CESR/08-1010) – Deutsches Aktieninstitut's considerations

6 February 2009

Introduction

In the wake of the global financial crises various supervisory authorities banned short sales in order to relieve the pressure on stock prices of – at least – financial institutions and to prevent serious systemic consequences for the global financial system as a whole. These ad hoc emergency measures have been welcomed by many observers. But regulatory actions also unfold the need to further examine both the positive and negative aspects of short selling with respect to market integrity and efficiency and to implement a long-term regulatory framework. For this purpose, CESR – among other international organisations – set up a task force on short selling.

Deutsches Aktieninstitut¹ appreciates the opportunity to provide CESR with some considerations on a possible regulation of short sales. These considerations are based on a broader feedback from German listed companies. In general, issuers are interested in a fair and internationally harmonised regulation of short sales, as their shares may be shortened and possible abusive behaviour will revert to the issuer itself.

Positive effects...

Short sales – as many other financial instruments – may have both positive and negative effects. As far as they are backed by stock lending, short sales may ease processes of arbitrage and valuation of securities, may contribute to market liquidity and may lower volatility of stock prices. Thus, in many circumstances short selling may stabilise security markets – at least under normal market conditions.

¹ Deutsches Aktieninstitut e.V. is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

... but serious problems

On the other hand short selling may also have completely contrary effects. When there is a widespread uncertainty among market participants short sales may worsen downturn trends in stock prices which, in turn, may have further negative consequences for the respective issuers and the economy as a whole. For example, access to finance usually depends on the level of share prices. Therefore any pressure imposed upon share prices by short selling may worsen (re-)financing conditions even for companies which are basically solvent. These are two of the reasons, why regulators imposed constraints on short selling – at least for some shares – during the financial crises.

But short sales may be problematic even in less turbulent times as short selling may be linked to attempts to manipulate the market. By selling shares short and subsequently floating rumours about an unsustainable overvaluation in the market one can extract enormous private profits from a later decline of share prices during a very short period of time. Manipulative behaviour of this kind seriously damages market integrity and efficiency, but cannot be easily uncovered. The same is true when other events with negative consequences for issuers and their shareholders are caused or promoted by short selling. There is, for example, evidence that speculators massively shortened shares in order to achieve a company being excluded from a stock market index, which normally leads to a long-term loss of liquidity and a long-term fall of the price in the respective share at the expense of all other shareholders.

For the above mentioned reasons, Deutsches Aktieninstitut is of the opinion that regulations to prevent market manipulation by floating rumours should be reviewed and, if necessary, tightened. Additionally, there is a need to implement a specific regulation with regard to short selling that does not eliminate its positive effects while at the same time taking into account negative effects on market integrity and efficiency.

Prohibition of naked short sales (uncovered short sales)

The danger of market manipulation is particularly virulent with so-called naked short sales which are not covered by ex-ante stock lending, so that risks clearly exceed benefits for this kind of short selling. As a consequence, naked short sales should be prohibited internationally and any violation of this prohibition should be sanctioned appropriately and effectively. The emergency measures taken by authorities during financial crises could serve as a role model for future regulation.

As naked short sales are not backed by a stock lending agreement there is no contractual or legal relationship between the lender and the borrower that could – at least indirectly – narrow the room for manipulative behaviour.

Furthermore, naked short sales may lead to an over-supply of shares in the sense that the number of shares on the supply side of the stock market exceeds the number of shares economically available or even the number of shares that are booked into security accounts.

Transparency of covered short sales

In contrast to naked short sales, covered short sales should not be prohibited, but made transparent to supervisory authorities and to the public (starting from a certain threshold). A higher level of transparency would strengthen market integrity for at least three reasons:

- If short selling positions were to be made transparent, market participants and issuers could assess whether there are investors interested in falling stock prices and, accordingly, rumours could be judged against this background. As a consequence, manipulative behaviour could be much better prevented. Additionally, a transparency obligation for short selling would be the logical complement to the existing one with respect to long position in shares and financial instruments.
- Furthermore, transparency obligations for short sales would prevent extreme shortenings of certain shares and would therefore protect short sellers themselves. Each potential short seller will be more cautious if there is already a high level of short sales in a respective share. This would prevent extreme increases in stock prices what happens, when many short sellers have to buy shares for any price in order to limit losses or to meet contractual commitments.
- If there was a complement obligation to notify stock lending, transparency of short sales would indirectly enhance knowledge about the potential of so-called “empty voting”. There is evidence that stock lending has been used to raise voting power in general meetings without being invested long-term in the respective company or even interested in the long-term performance of the share.

Details of transparency rules

An appropriate transparency obligation should have the following shape:

- Building up and reducing short selling positions should be made transparent immediately starting from a low threshold (for example 0.25 percent of outstanding shares). A low threshold is important as short sales influence the trading of securities and the level of prices. To the contrary, obligations to notify long positions aim at informing the market on the long-term voting power of important shareholders, so that long positions should be treated differently to short positions.

- There should be safeguards to prevent notification obligation in the cash-market from being circumvented by building up synthetic positions, so that – principally – synthetic shortening should be included in the regulation. It is well-known that there is a close correlation between the prices of derivative financial instruments and the prices of underlying securities. Therefore a synthetic short sale has similar effects on the price of a (underlying) share as a short sale in the cash market. Additionally, in both cases short sellers are interested in falling prices.
- Short sales should be notified to a supervisory authority which, in turn, summarises the notifications and makes them transparent immediately to all market participants.
- For this purpose a central and international register could be created. This would pay tribute to the fact that it is possible to shorten the same stock in different local markets. In order to achieve market integrity it is important to know both the worldwide level of short sales and the short selling investors.

International harmonisation and enforcement of a regulation

Having in mind that financial markets are global and that there are close correlations between the prices of securities in different local markets, both the prohibition of naked short sales and the notification requirement for covered short sales should be harmonised internationally. Harmonisation includes that regulations are consistently enforced by different national regulators.