

**ABI's remarks on CESR's
proposal for a Pan-European
Short Selling disclosure regime**

30/09/2009

Introduction

The ABI (Italian Banking Association) is pleased to contribute to the debate on defining Community regulatory initiatives on short selling in its role as the representative of the Italian banking industry. Short selling is a crucial activity for banks as it is a tool used by intermediaries and investors in their pursuit of investment choices, as well as an important element in maintaining a balanced and efficient market.

We appreciate CESR's intention to address the matter fully at the Community level, in order to avoid any adverse effects concerning unequal treatment resulting from the adoption of sometimes varying national regulations by the different Member States. In fact, it is always necessary to take into consideration the ultimate goal, which is to create a level playing field able to eliminate the differences in valuation and treatment on the various markets and, for that purpose, to underscore the need for the adoption of a single Community regulation, should it so be decided.

We first note how, as already expressed in similar national consultations, the costs of implementation and compliance connected with a regime of transparency on short selling do not equal the benefits that would be derived therefrom, and the causality between short selling and phenomena such as excessive volatility and market manipulation is not certain. Any measure on the matter, in fact, could actually discourage, directly or indirectly, the use of short selling, with noticeable consequences on the efficient functioning mechanism of markets and price discovery.

At the same time, we highlight the risk that the complexity of calculating accurate data may result in information that, rather than being beneficial for the market, would have distortion effects.

There is no apparent market or regulatory failure that would justify, in accordance with the international best practice on matters of better regulation, any regulatory intervention with respect to short selling.

That said, a solution that would impact the system less, should measures be deemed necessary on short selling, could be the implementation of a transparency regime on the net short positions taken by the individual investors, but only vis-à-vis the Authorities, and if sufficiently high thresholds are exceeded. Nevertheless, we cannot underestimate that a reporting regime could also, especially if directed at the market, have the implicit impact of forestalling short selling, even to a considerable degree.

Answers to specific questions

The answers to the questionnaire attached to the consultation document are given below.

1. Enhancing short selling transparency

Q1) Do you agree that enhanced transparency of short selling should be pursued?

No, we do not believe it is necessary to increase the level of transparency in relation to short selling. Communicating this information, to the market and Authorities, would not result in significant advantages and could actually be potentially harmful, outweighing any possible advantages.

We do not agree with the proposal of providing disclosure to the market since we believe that informing the market of positions held would make investors and intermediaries particularly vulnerable to any “adverse” conduct by other participants. Furthermore, it could have the effect of further discouraging intermediaries from placing short sales, thereby depriving the market of a tool that facilitates correct price discovery.

However, disclosure to Authorities appears to be a solution that would impact the system less, as it would provide more protection to investors and intermediaries from the aforesaid effects and be less costly and more efficient than disclosure to the market. Specifically, the costs associated with disclosure obligations vary according to the threshold above which the net short position is flagged and therefore to the frequency of flagging.

On the other hand, a symmetrical disclosure requirement could be imposed on buy-side transactions if financed by borrowing (such behaviour would have similar impact on market volatility).

Q2) Do you agree with CESR’s analysis of the pros and cons of flagging short sales versus short position reporting?

We agree with the analysis conducted by the CESR in identifying the pros and cons of flagging and disclosure, nevertheless, an important fact has been underestimated i.e., flagging and reporting of net short positions taken by investors to the market require very high compliance costs: if on the one hand flagging requires adjustment costs of the trading platforms, then on the other, calculating the net short position could prove to be particularly onerous and complex (the broader and more intricate the trading transaction conducted is).

Q3) Do you agree that, on balance, transparency is better achieved through a short position disclosure regime rather than through a ‘flagging’ requirement?

Although we do not believe that it is necessary to provide transparency to the market in relation to short selling, we do however agree that the inherent inefficiencies in flagging make disclosure of the short positions taken in securities preferable.

2. Proposed model for the disclosure of significant short positions

We do not believe that the anticipated benefits from the model of transparency of the net short positions are sufficient to justify legislative intervention. As already mentioned, the implementation costs that the system would incur (in terms of the costs of updating systems and compliance costs) would be greater than the advantages that its introduction would bring. The indirect costs related to the introduction of the disclosure regime, deriving from the impact that it could have on the efficiency of the markets, must also be added to these. Specifically, the costs of disclosure obligations would discourage the use of short selling, thus limiting its positive effect in terms of market making efficiency.

Q4) Do you have any comments on CESR's proposals as regards the scope of the disclosure regime?

Although we are convinced that it is not necessary to introduce any disclosure system on the net short positions deriving from the short selling of securities, we deem however that for the transparency model to function, it is necessary to have uniform characteristics and ensure an application thereof. This is to avoid creating any unequal treatment and imbalances on the various markets. We believe that, especially for banking intermediaries, clear calculation methods of thresholds, identification of the scope of the regime and exemptions must be provided.

Specifically, we agree with CESR's approach, which provides for undifferentiated disclosure regime for all shares, without distinguishing the functional sectors to which the issuers belong.

Nevertheless, the concept of "economic exposure" referred to by the CESR should be further clarified as regards the identification of the application field of the proposed regime, as the criterion at the root of its definition is not understood.

In addition, a clear definition of "net short position" should be given (i.e. if a short sale is hedged with a call option would this position be relevant).

Q5) Do you agree with the two tier disclosure model CESR is proposing? If you do not support this model, please explain why you do not and what alternative(s) you would suggest. For example, should regulators be required to make some form of anonymised public disclosure based on the

information they receive as a result of the first trigger threshold (these disclosures would be in addition to public disclosures of individual short positions at the higher threshold)?

We do not agree with the proposed system, which is based on disclosing information to the market and Authorities. This is because disclosing information to the market should always be avoided and the resulting negative effects on the market must never be underestimated, as illustrated by the CESR (please refer to Q1 above).

With regard to disclosing information to the Authorities, this measure is less invasive and therefore preferable with respect to disclosing information to the market, however we are still concerned about the effectiveness of disclosing information to the Authorities, in relation to the purposes identified by the CESR.

Moreover, for the past two years, the Authorities have been receiving a significant volume of information on the trading-related activities on shares listed on the regulated markets through the Transaction Reporting mechanism. This system, which the industry played a significant part in developing, has already resulted in significant charges to the financial system.

To that effect, therefore, a mechanism based on reporting net individual short positions to Authorities sent by individual investors holding such positions exceeding determined thresholds, would have a lower impact.

These thresholds should be fixed at a level such as not to indirectly discourage the use of short selling, and the information originating from the reports must accordingly be kept confidential by the recipient Authority, used only for monitoring and supervisory purposes and not disclosed to the public.

Furthermore, for the purpose of avoiding regulatory arbitrages and unequal treatment, we believe it would be appropriate to set uniform thresholds for all EU jurisdictions.

Q6) Do you agree that uniform pan-European disclosure thresholds should be set for both public and private disclosure? If not, what alternatives would you suggest and why?

As indicated in Q5 above, we do not believe that any disclosure system to the market on net short positions should be adopted.

We agree with the proposal not to make the disclosures periodic, but subject to reaching certain thresholds, as this makes such information more relevant. In the same vein, we agree with the CESR that the thresholds must be fixed by taking into account that an excessively high threshold

would lose meaningfulness and generate information of little significance, with consequent unnecessary costs. An excessively low threshold, instead, would de facto discourage short selling. This is because an excessively low threshold would generate very high disclosure costs and, where disclosure is directed to the public, would risk exposing the party to adverse market conduct.

We do not agree, moreover, with differing thresholds based on the characteristics of the securities or of the markets on which the net short positions are taken. In fact, for the purpose of pursuing harmonisation of the regulation at Community level, we believe that the identified disclosure threshold must be uniform and not differentiated by security or country, as this would lead to unequal treatment and, consequently, of discriminatory behaviours from investors who would prefer certain securities over others.

Q7) Do you agree with the thresholds for public and private disclosure proposed by CESR? If not, what alternatives would you suggest and why?

The threshold system presented clearly distinguishes between the obligation of disclosure to Authorities (0.1%) and that of disclosure to the market (0.5%), fixing, however, some equal upward or downward rungs (0.1%).

The identified thresholds are excessively low and, as such, penalise investors for the reasons referred to in Q6 above and indicated by the CESR in the document. Rather, it would be more appropriate to first identify thresholds at a level deemed acceptable and, thereafter fine-tune them, adjusting them so as to verify their suitability with respect to market conditions.

For this reason, a preliminary evaluation of the relationship between the fixed thresholds, compliance costs and the effects on the market would be necessary so as to minimise the impacts of the disclosure system on the market.

In this perspective, the obligation to communicate the net short positions only to Authorities would prove to be less onerous, i.e. identifying a higher disclosure threshold reasonably fixed at 2%. Furthermore, the information received must not be made public, in order not to prejudice the interests of the investors and undermine the market functioning mechanism.

With respect to the definition of subsequent rungs, the adoption of a threshold system similar to that envisaged under the Transparency Directive for the disclosure of major holdings could be considered.

Q8) Do you agree that more stringent public disclosure requirements should be applied in cases where companies are undertaking significant capital raisings through share issues?

We do not agree with this proposal, as it would create unequal treatment with respect to other corporate securities of enterprises not contemplating capital increases and this could have negative effects on the trading and liquidity of such securities.

However, short selling is an operating tool that can help render these corporate transactions successful and imposing an excessively low disclosure threshold could discourage its use, placing the success of the transaction at risk.

Q9) If so, do you agree that the trigger threshold for public disclosures in such circumstances should be 0.25%?

Please refer to Q8.

Q10) Do you believe that there are other circumstances in which more stringent Standards should apply and, if so, what standards and in what other circumstances?

We note that in the event extraordinary situations arise, downgrading the disclosure thresholds could be justified as an exceptional and transitory measure to better monitor the market in conditions of stress and contribute to the return of trading to normality. This would always ensure coordination at Community level to avoid uncertainties and evaluation differences on the various markets.

Q11) Do you have any comments on CESR's proposals concerning how short positions should be calculated? Should CESR consider any alternative method of calculation?

Although we do not consider it appropriate to set any transparency obligations, we do however agree that the position to be disclosed must be that of net short selling and not gross: Utilisation of the gross position could generate information of little significance and not representative of the real position. Furthermore, the possible higher cost of calculating the gross, rather than the net, position must also be taken into account.

It is preferable that the object of disclosure is the individual position taken by each legal entity and not the consolidated position at group level (not only to reduce the netting effect between the positions but also for the purpose of avoiding onerous operating procedures, particularly significant for structured banking groups with international locations).

The power to delegate a party designated within the group to report the individual net short positions of each legal entity belonging to the group could be considered.

Furthermore, with regard to the calculation method for the positions that are the object of disclosure, although the lack of uniformity of the calculation models could risk a distortion of the information diffused, we still believe that intermediaries should be free to choose the method to be used. This is in order to minimise costs of updating the system for the eventual implementation of methodologies not used by all intermediaries.

Q12) Do you have any comments on CESR's proposals as regards the scope of the disclosure regime?

The proposal to send disclosures by e-mail is acceptable. Nevertheless, where other means of electronic communication that allow a higher automation level are made available by the individual Authorities, these should be used, in order to guarantee greater integrity and confidentiality of information.

Q13) Do you consider that the content of the disclosures should include more details? If yes, please indicate what details (e.g. a breakdown between the physical and synthetic elements of a position)

No, the content of CESR's communication proposals appear to be sufficiently exhaustive.

Q14) Do you have any comments on CESR's proposals concerning how short positions should be calculated?

We agree with the proposal providing that disclosure is made in T+1 directly by the party who holds the position, upon exceeding the threshold, without encumbering intermediaries with further charges.

Q15) Do you agree, as a matter of principle, that market makers should be exempt from disclosure obligations in respect of their market making activities?

It is correct to exempt market makers, in the event disclosure obligations on the net short positions are imposed, with regard to positions taken in the course of their activities. This is because these parties must be free to conduct normal business, including short selling, since the purpose they pursue is that of favouring market liquidity, correct trading and pricing.

Q16) If so, should they be exempt from disclosure to the regulator?

Yes, as stated in Q15 above, market makers must be automatically exempt from any disclosure obligation.

Q17) Should CESR consider any other exemptions?

We believe that for the same reasons given for exempting market makers, specialists and liquidity providers must also be exempted from any disclosure obligation, since they conduct a business that is de facto similar to that of market makers.

Q18) Do you agree that EEA securities regulators should be given explicit, stand-alone powers to require disclosure in respect of short selling? If so, do you agree that these powers should stem from European legislation, in the form of a new Directive or Regulation?

We agree that disclosure obligations must be imposed on all holders of net short positions without any possibility of evasion and consequently also with an ad hoc regulation that governs these disclosure obligations.

However, achieving a level playing field at Community level is the primary goal and to that end, the most appropriate legislative tool guaranteeing real harmonisation is regulations.

With respect to the power of the individual national Authorities, we hope that they will not have the discretion to set varying measures at the local level.

3. Impact Assessment

In addition to the observations already illustrated in the previous responses, we consider it appropriate to remark specifically on the impact assessment of the proposed regime on.

In the first place, we consider that the fact should be highlighted that, in the face of certain costs (even if not quantified) to be borne by operators to implement adequate systems for the proposed disclosure regime and, above all, in the face of the risk of negative effects on market efficiency, it has not been proven that the possible benefits (including those not quantified) outweigh the negative effects.

The complexity of the matter and degree of uncertainty on the net benefit of the proposed legislation appear such as to justify an in-depth impact assessment¹ that possibly is of a quantitative character.

The fact that in certain Member States, measures similar to those proposed have already been adopted, even if only temporarily, should have permitted analyses directed at verifying the effective attainment of benefits, as well as giving indications relating to the costs incurred by operators.

¹ We refer to the "Impact assessment guidelines for EU Lamfalussy Level 3 Committees" that recommends that impact analyses be proportional to the "significance, complexity and uncertainties" of the problem.

It would have been appropriate² to set the general goals of enhancing transparency and reducing the risk of market abuse and disorderly markets, into specific sub-goals, whose achievement would represent the concrete manifestation of the benefits of the proposed regulation.

Some useful indicators to verify the attainment of the expected benefits could have been linked to these sub-goals. Such verification is, however, mentioned in the document with reference to the fine-tuning of the disclosure thresholds; there is no clarification on the basis of which criteria the identified thresholds will be considered as efficient or not.

We also note that, in the discussion of the envisaged impacts, the costs that are being identified seem too low. The legal and reputational risks that are borne by operators for any errors in disclosure are not mentioned, a not insignificant risk given the complexity of the calculations to be made to determine net position.

An observation relating to the effects of the level of the disclosure thresholds, in terms of costs, can also be ascribed to this aspect. We agree with the fact that the thresholds do not particularly affect the initial (one-off) implementation costs. However, a low threshold, resulting in an increase in the number of disclosures to be made, has significant repercussions in terms of recurring (on-going) costs

Each report, in fact, does not only consist of its mere communication, but also assessments of the technical and legal aspects. According to the estimates provided to the Association by some intermediaries, on the occasion of the national consultation on short selling, a disclosure regime for net short positions with a 0.25% threshold would entail high compliance costs of between 50,000 and 10 million euro for the one-off costs and between 15,000 and 2.5 million for on-going annual costs. In this connection, it is noted that a threshold fixed at 2% would entail cost levels equal to about one third of the annual costs that would apply with the 0.25% threshold.

In the second place, we note that the timing necessary for updating to the proposed regime and the connected legal risks borne by obliged entities, could probably result in a suspension of short selling transactions, particularly in the early period of its application, with basically the same effects as imposing a ban.

In this connection we also note that intermediaries with broad and complex operations, argued that they might opt out of short selling, in cases where the costs and risks related to any transparency obligations appear to be

² As envisaged, moreover, by the "Impact assessment guidelines for EU Lamfalussy Level 3 Committees"

greater than the benefits from the strategies implemented through short selling.

It therefore seems that not enough attention has been given to the fact that imposing disclosure obligations could plausibly entail a reduction in short selling transactions, precisely due to compliance costs, legal risks and, in the case of disclosure to the market, the risk of a short squeeze.

This would entail negative effects such as reduced market liquidity, inefficiencies in the market making process, as well as a reduction in operators' profits, as they would be forced to adopt sub-optimal strategies for achieving their investment strategies.