BUSINESSEUROPE

COMMENTS

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STAKEHOLDER CONSULTATION ON SHORT SELLING

Introduction

BUSINESSEUROPE supports the development of a European short selling regime in separate stand alone legislation which would allow no exceptions for the individual Member States. The different reactions from Member States to short selling issues and the resulting fragmented approach with a variety of measures being put in place at national level harms the functioning and integrity of the single market.

The issue of short selling should also be addressed at a global level considering that it is likely that diversion of the capital involved in European short selling to other jurisdictions outside the EU such as the US or Asia would undermine the effectiveness of an EU regime.

Any regime, whether European or global, should only apply to emergency situations and/or extreme market conditions where there is a serious threat to financial stability.

A notification system should be set up to determine whether such an emergency situation exists which would entail an obligation for the market to give prior notice to the relevant competent authority of any relevant short selling activities. Short selling should thus be made subject to a reporting regime that provides timely information to the market or to market authorities. If short selling positions were to be made transparent, market participants and issuers could also assess whether there are investors interested in falling stock prices and, accordingly, rumours could be judged on the basis of this information.

Regarding the issue of uncovered short selling, where sales are not backed by a stock lending agreement and where there is no contractual or legal relationship between the lender and the borrower that could narrow the room for manipulative behaviour, BUSINESSEUROPE believes that there is currently a lack of evidence suggesting a complete ban. Should such measures nevertheless be contemplated, then a comprehensive and thorough impact assessment must be carried out to avoid unintended consequences and get the facts right.

Questions

1. *Which financial instruments give rise to risks of short selling and what is the evidence of those risks?*

   The question may be biased, as no instrument per se gives a specific risk of being shorted more than others. Short selling normally contributes to efficient markets and is technically the opposite of a long position. However, the risks associated with short selling may especially be virulent with the equity market.

   Most of the risks of short selling shares are already reflected in regulators' work on the issue of short selling. For example Appendix II of IOSCO's final report on regulation of short selling (June 2009) lists three main regulatory concerns: Disorderly markets: Short sales may (1) worsen downturn trends in stock prices which, in turn, may (2) have further negative consequences for the respective issuers and the market as a whole. Market abuse: Short sales may be problematic even in less turbulent times as short selling may be linked to attempts to manipulate the market. Settlement disruption: Furthermore the short sale of a share may cause problems at the time of settlement. On the one hand, a buyer will not be able to use voting rights as anticipated if a trade fails because a short seller is not able to deliver. On the other hand, the short seller himself will get into troubles if he needs to buy shares at any price in the market.

   If a permanent regulation of short selling in the equity market that contains the requirements discussed (transparency obligation, restrictions to short selling) would also be applied to financial instruments other than shares, negative side effects would result for corporate and other end users hedging activity. See also our response to question 2.

2. *What is your preferred option regarding the scope of instruments to which measures should be applied?*

   Option B, with a focus on equities and sovereign bonds.

   Option A is too vague and non–specific. The impact of such a broad scope is hardly foreseeable and there is a substantial risk that common and legitimate instruments to hedge future business risks will be considered as "prohibited" short sales, as the underlying business is planned and expected but not existing at the time of trading. This would compromise corporates' ability to hedge current and future business risks efficiently and effectively. Short sales in currencies, interest rates and commodities are standard when hedging operative business risks and there are no alternatives to these instruments.

3. *In what circumstances should measurers apply to transactions carried on outside the EU?*

   The rules should not have extra-territorial reach, but in case of a serious threat to the global economy, this might be conceivable. Specifically, all transactions

(shares and bonds) carried out on an EU regulated trading platform or OTC should anyway be covered.

4. *What is your preferred option in relation to the scope of financial instruments to which the transparency requirements should apply?*

   We favour Option B. Limiting the disclosure requirements to shares and – if necessary EU sovereign bonds – would best reflect our concerns to instil more harmonisation in the practices of MS regarding the treatment of short transactions. with a broad scope of a possible regulation. Furthermore, we consider it to be wise to restrict the regulation to transparency of short sales in shares, because this is the field which has frequently given reason to regulatory concern in the past. A differentiation between the specific financial instruments as well as the specific market participants would allow a more targeted reaction to market disruptions and to those market participants which caused disruptions. In addition, implementing individual rules for specific financial instruments instead of flatly applying the same ones to all types of instruments and to all market participants would reduce the administrative burden through lower monitoring and reporting requirements.

   In contrast, Option A would raise a number of important additional issues that need to be addressed carefully. For example, if derivative contracts in currencies, interest rates or commodities were to be made transparent, competitors would obtain information on specific hedging positions of other companies. Furthermore it has to be carefully defined what would constitute a (net) short position for reporting purposes. For example the hedging of future business risks should be out of the scope even if the underlying does not exist at the time of entering into the agreement. Otherwise the market would get misleading information.

5. *Under option A is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?*

   We favour option B and strongly believe that transparency requirements shall be limited to instruments admitted to trading on EU platforms. But given the very diverse market structures of the instruments, the rules shall be adapted to their specific market.

6. *Under Option B do you agree with the proposals for notification to regulators and the markets of significant net short positions in EU shares?*

   We would support the reporting of short transactions to the supervisors, and would further suggest that this information is aggregated (anonymously) and distributed so that a figure of total short positions relative to outstanding issue can be published; a tool that would be extremely useful for investors.

   We disagree with the limit proposed by CESR of starting reporting at very low positions (even if netted at firm level). BUSINESSEUROPE is of the opinion that the reporting should ideally be based on the Transparency Directive (TD) regime. The reasoning being that taking a short position should not be treated differently

from a long position. Furthermore, the information most valuable to the market is not who is behind a short position, but rather the evolution of the total short positions relative to the issue (a model used in the US). In addition the publication of the name of the participant that is short may act as kind of market signal and thus lead to further shorting.

Moreover, we are very concerned about the expected deterring effect that public disclosure of such information may have on the investors and its consequences, i.e. in limiting the practice for even the most legitimate use of market making or as a counterweight to market perceived overvaluation, given the name and shame pressure of this type of reporting if not aligned on the TD.

We are opposed to a reporting to the supervisory authority of Member States for CDS on sovereign debt where the authority may be in the difficult position of knowing who is holding CDS on its debt and at the same time forbidden to use this information in naming and shaming the specific investor, thus effectively being judge and jury. BUSINESSEUROPE here identifies a clear case of conflict of interest.

7. *In relation to Option B do you agree with the proposals for notification to regulators of net short positions in EU sovereign debt (including through the use of CDS)? In addition to notification to regulators should there be public disclosure of significant short positions?*

   No. It does not appear that there has been a dramatic rise in the CDS positions taken on specific sovereign debt, but rather that they are now better reflected. The moves seem to be mainly driven by fundamental market views rather than anything else.

8. *Do you agree with the methods of notification and disclosure suggested?*

   We are opposed to any requirement for the disclosure of short positions to the market. Markets are places where buyers and sellers meet.

   The rules for reporting and calculating the short positions will also have some importance in the way information is disclosed. The more complex the regime, the longer the time allowed for reporting. At a minimum, disclosure shall be T+1.

9. *If transparency is required for short positions relating to sovereign bonds, should there be an exemption for primary market activities or market making activities?*

   Yes, intermediaries that need to take technical short position even if not covered shall be exempted, thus at least market making and primary market activities should be excluded from the short selling rules a well as operators of entities that may not as required by regulation (national or otherwise) have other than technical temporary short positions (some UCI). In addition there needs to be some proportionality in the regime depending on the size of the institutions concerned given the low thresholds for reporting as proposed by CESR.

10. *What is the likely costs and impact of the different options on the functioning of the financial markets?*

    New reporting rules will inevitably add costs for the industry and investors, but, as long as the rules are not final, quantification at this stage is difficult. In any case, the more complex the regime, the costlier it will be.

11. *What are the risks of uncovered short selling and what is the evidence of those risks?*

    In the case of uncovered short selling, sales are not backed by a stock lending agreement and there is thus no contractual or legal relationship between the lender and the borrower that could narrow the room for manipulative behaviour.

    Uncovered 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.

    Having said this, there is no absolute evidence of additional risk created by short transactions, except that under some circumstances it may be difficult to buy the instrument to close the position. It is important that a comprehensive and thorough impact assessment is carried out to avoid unintended consequences and get the facts right. Devising the right financial market regulation is a difficult and complex task which should be based on sound evidence.

12. *Is there evidence of risks of uncovered short sales for financial instruments other than shares (e.g. bonds or sovereign bonds) which would justify extending the requirements to these instruments?*

    No comments.

13. *Do you agree with the proposed rule setting out conditions for uncovered short selling? Do you consider that more stringent conditions could be put in place? If so, please indicate which ones? Do you agree that arrangements other than formal agreements to borrow should be permitted if they ensure the shares are available for borrowing at settlement? If so, why?*

    Yes, see our response to question 14. It's worth mentioning that the evaluation of whether a person entering into the sale of an instrument has borrowed the instrument shall be evaluated at the earliest at the end of the day.

14. *Do you consider that the risks of uncovered short selling are such that they should be subject to an upfront ban/permanent restrictions? If so, why?*

    No. There is currently no evidence that would support such a measure. See our response to question 11. It is also important not to act under short term political reasoning. If a pan-EU regime were to be put in place this would facilitate the operational procedures and likely reduce the risks of failure.

15. *Do you agree with the proposal requiring buy in procedures for settlement failures due to short sales? If so, what is an appropriate base period that could be specified before buy in procedures are triggered (e.g. T + 4)?*

    No. We see some cause for concern regarding the emphasis put on post-trade operators (CSDs/settlement systems, or even CCPs) as the changes may require to track the direction of transactions at their level, which is not an easy task as an operational process. Moreover, in the context of major changes to come, such as the centralisation of settlements on the ECB's T2S platform and a new CCP regulation, post trade operators may be in a difficult situation were a new legal obligation with technical implications to arise.

16. *Do you consider that there should be permanent limitations or a ban on entering into naked credit default swaps relating to EU sovereign issuers? If so, please explain why, including if possible any evidence relating to the use of naked CDS.*

    No. In any case, in situations where a CDS is held against a corresponding position in a related (even indirectly related) instrument then it may not qualify as a naked short. Until now no clear evidence has demonstrated the adverse effects of CDS dealings, given the relative size of the market compared to outstanding amount of debt issued. More research may thus be necessary on this aspect.

17. *Do you consider that in addition to the measures described above there should be marking of orders for shares that are short sales?*

    No. We hold the view that Transparency Directive rules shall apply to both directions; the only additional information useful for investors would be an aggregated view of all the short positions on a given issue. The investor shall do the reporting.

18. *What is the likely costs and impact of the different options on the functioning of the financial markets?*

    BUSINESSEUROPE is not in a position to answer the question, but emphasizes that reporting's are always costly to set up and cost is increase by complexity.

19. *Do you agree with the proposed exemption for market making activities? Which requirements should it apply to?*

    Yes but it should be applied narrowly and carefully given the fact that any regime should only apply to extreme market conditions (see our response to question 27).

20. *Do we need an exemption where the principal market for a share is outside the EU? Are any other special rules needed with regard to operators or markets outside the EU?*

    No considering that any regime should only apply to extreme market conditions (see our response to question 27). EU rules shall not have extraterritorial impact:

third countries markets are governed by their own rules, rules to which EU institutions, if present there, shall abide.

21. *What would be the effects on the functioning of markets of applying or not applying the above exemptions?*

    The main consequence would be dual reporting under different rules for the same instrument. This would result in unnecessary increased costs and no new/usable information for authorities in the EU/EEA, as well as a risk of false market abuse cases. Concretely a Member State supervisory authority may not have the powers to sanction behaviour outside the EU and even its border, to the risk of extraterritoriality.

22. *Should the conditions for use of emergency powers be further defined?*

    Yes. This would help a drive toward harmonisation. Clear criteria shall be defined to help market participants know when the "limit may be reached"

23. *Are the emergency powers given to Competent Authorities and the procedures for their use appropriate?*

    These powers should be determined in global perspective, to ensure full harmonisation from the outset of the emergency situation. There must be strong procedures to ensure that the information is transmitted to all stakeholders (market participants and other authorities) in due time.

    BUSINESSEUROPE considers that these emergency procedures are suited only for equities, bonds and equities related instruments and not for CDS which are not presenting market risks for systemic stability.

24. *Should the restrictions be limited in time as suggested above?*

    The restrictions should be temporary but continue as long as necessary with a fixed period of time.

25. *Are there any further measures that could ensure greater coordination between competent authorities in emergency situations?*

    Given the importance of a level playing field and regulatory arbitrage the goal should be to develop a global regime for short selling.

26. *Should competent authorities be given further powers to impose very short term restrictions on short selling of a specific share if there is a significant price fall in that share (e.g. 10%).*

    No comments.

27. *Should the power to prohibit or impose conditions on short selling be limited to emergency situations (as set out in the previous section)?*

Yes.

28. *Are there any special provisions that are necessary to facilitate enforcement of the future legislation in this area?*

    No comments.

29. *What cooperation powers should be foreseen for ESMA on an on-going basis?*

    There should be maximum coordination and cooperation at European level.

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