HFSB Response to the European Commission Public Consultation on Short Selling

Introduction

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to them. It is also responsible for ensuring that the Standards are updated and refined, as appropriate. Almost 60 managers from the UK and abroad, accounting for over USD 200BN in assets under management, have already committed to the HFSB process, and more are expected to sign up to the Standards over the coming months. The HFSB expects its Standards to be widely adopted and a growing number of investors to apply them in their due diligence. Policy leaders trust that the HFSB will implement this market-based regime and encourage its adoption by the industry.

The Hedge Fund Standards Board (HFSB) is pleased to respond to the European Commission Consultation on short selling[1]. The HFBS has in the past participated in various other consultations on short selling, notably:

- Committee of European Securities Regulators (CESR) call for evidence on regulation on short selling (01/2009)
- IOSCO Consultation on Regulation of Short Selling (05/2009)
- FSA Consultation on Short Selling (05/2009)
- HFSB Consultation response to CESR/09-581 (09/2009)

The European Commission rightly points out that short selling plays an important role in global financial markets. In light of the recent volatility seen in Euro-denominated bonds, **the HFSB finds it important to highlight that the most important issue for the EU governments is how to restore investor confidence, and how to encourage investors to buy risky sovereign bonds.** Restrictions on short selling can be counterproductive: the ability to manage risk via short selling and derivatives makes it far more attractive for investors to stay in the market even when the prices are volatile or

[1] http://ec.europa.eu/internal_market/consultations/docs/2010/short_selling/consultation_paper_en.pdf

declining. Without this, investors are more likely to withdraw, accentuating the market contraction during major crises like the present one.

In the interest of "better regulation", a solid analysis of the "issues" would be helpful in devising the right regulatory tools and instruments.

Consultation answers

A: SCOPE

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

It is important to highlight that short selling is not a risk in itself and brings many benefits to markets (as the Commission has rightly highlighted in the introduction). Therefore, the issue is dealt with in two steps:

a) Where can short selling occur?

b) In what instances can *short selling potentially give rise to certain risks*?

a) Short selling can occur in cash instruments (mainly equities, less wide spread for bonds). The economic exposure of a short sale can be replicated with derivatives, but such transactions do not constitute a short sale.

b) To assess risks arising in the context of short selling, it might be helpful to define precisely the "risks" (or better potential failures) that we are concerned about upfront and classify them according to common regulatory objectives, such as market integrity, systemic stability and (retail) investor protection.

The following table draws upon the various potential issues the Commission has alluded to in its paper and seeks to categorise them accordingly:

Potential failure	Category	Observation
driving down prices in an abusive fashion and contribute to disorderly markets	**Market integrity?**	• The less there is liquidity in the market, the higher the likelihood of any large transaction moving the market (both positively or negatively). This is also called market impact. • However, on every short sale, there is a buyer, who will benefit from a lower acquisition price for the asset than in a situation where short selling has not occurred. • Also, a falling price might provide an incentive for other market participants to start buying. • <u>Ultimately, this is what markets are all about: price discovery by balancing supply and demand.</u> • Therefore, the quicker disorderly (e.g. falling) markets find a level where buyers are willing to step in, the better. • If the Commission were to seriously pursue this "failure", first of all,

Potential failure	Category	Observation

		it would have to establish what constitutes a disorderly market and then distinguish it from justified price corrections.
		• This approach raises many issues:
		  ○ It assumes superior knowledge of the "right price".
		  ○ Regulatory intervention can give rise to "first order errors", whereby a market intervention prevents a justified price correction from happening (i.e. hurting market integrity)
		  ○ It is also important to keep in mind that intervention / restriction of market activity (e.g. temporary short selling restrictions) might then very well exacerbate the distress: The regulator signals that there are concerns about market integrity, resulting in even more investors withdrawing from the markets.

amplifying price falls	**Market integrity?**	• There is only weak evidence that supports the view that short selling constraints help prevent financial panics.[2] The 2008 banking crisis showed that a short selling ban had not prevented banking stocks from falling further. It merely resulted in a brief artificial rally, and only delayed market corrections at sustainable levels (-> the ban hurt market integrity!). • Obviously, there was a real underlying cause for falling stock prices of banks during the 2008 banking crisis. • In such instances, regulatory focus should not be on short selling restrictions (which is merely "shooting the messenger"), but on measures that increase confidence in the banking sector (i.e. initiating recapitalisations). • In addition, short selling helps accelerate price corrections, ensuring that investors do not overpay, thus <u>enhancing the attractiveness of a market place</u> for all investors (and in particular for long only or index investors). • It should not come as a surprise that assets / companies / banks / governments through their own manoeuvring push themselves to the point of bankruptcy, will face severe volatility and end up trading at a discount. But this severe sanction is exactly what provides the incentive for responsible management and serves as a strong deterrent to wasteful behaviour/excessive debt. <u>Trying to ease this market sanction merely increases moral hazard.</u>
adverse effects on	**financial**	• The HFSB is not aware of any cases where short selling has adverse effects on financial stability. On the contrary, the knowledge that

[2] See Efficiency and the Bear: Short Sales and Markets around the World (Bris, Goetzman, Zhu), Working Paper 9466, National Bureau of Economic Research Working Paper (01/2003)

Potential failure	Category	Observation
financial stability	stability?	markets can use sanctions against waste and reckless behaviour enhances the discipline of those using capital. • In fact, the quicker markets use sanctions against wasteful or reckless behaviour (whether by corporates, banks, or governments), the better. • Thereby, short selling can contribute to smooth bubbles and help to reduce the risk of even larger price corrections and more severe distress. [3]
resulting in information asymmetries	unclear	• Short selling does not result in information asymmetries, but can be a reflection of information asymmetries in the market: An investor who puts a lot of effort in research may well gain insights that other market participants might not have, and short selling (or buying) allows this investor to capitalise on this "research effort". • The quality of the market place increases with the increasing number of such "informed" investors. At the same time, such a market place becomes more attractive for "uninformed" investors as well, since the risk of mispricing is significantly reduced. • However, it is important that the incentive to be "informed" remains intact (i.e. an investor has a return on his research effort), otherwise, such information acquisition would be discouraged (e.g. if investors had to publicly disclose their short or long positions at very low thresholds).
risk of settlement failures	Market integrity	• Settlement failures damage a market place; and sanction is the best prevention mechanism.

The assessment highlights that the risks are not yet clearly identified, and that potential measures to address the risks could be even counterproductive (i.e. introducing moral hazard, damaging market integrity, etc).

Therefore, it is very important that the "risks" are thoroughly assessed before the measures to address them are determined. It would be detrimental to the European Capital markets if the

[3] Several Hedge Funds shorted Greek and Portuguese government debt several years ago, precisely because they felt that their finances were not sustainable. They might have dampened the narrowing of spreads on these sovereign bonds, but failed to make any money, because the markets did not follow them. This shows two things: 1.) Short selling has only limited capacity to influence prices; 2.) If they had succeeded, the prices would have adjusted, investors would have observed the signal and the crisis would have stopped much earlier, with the appropriate measures taken before the situation got out of control. The lesson is that more active investors are needed, and that restrictions on short selling can result in slowing down price discovery, prolonging imbalances and ultimately worsening crises.

measures intended to enhance market integrity, end up having the opposite effect, i.e. make the European capital markets less attractive and increase funding costs for economic activity.

Market Integrity

Maintaining market integrity refers to the ability of investors to transact in a fair and informed market where prices reflect information. Market integrity is key in attracting investors and is the main objective of market regulators. A lack of market integrity can deprive honest investors of their capital, reduce investor confidence, reduce liquidity, and ultimately increase cost of capital. Therefore, the impact for the wider economy is real and concerns about market integrity should be taken very seriously.

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

The scope should be a function of where "failures" occur. So far, there is weak evidence of market failures related to short selling.

In order to properly explore these areas, it might be helpful, first of all, to develop sound hypotheses about potential failures[4], secondly, assess and verify/discard the hypotheses, and, thirdly, determine regulatory measures that could address these failures. Finally, it is also important to assess the impact of the regulatory measures, to prevent second order effects which could potentially further hurt market integrity etc.

Without a proper assessment and identification of the exact failures, it is hard to suggest the perimeter of any regulatory measures. Based on the assessment above, there is very weak evidence of significant failures, however, the regulators should further explore as to whether settlement failures damage the market place, and if it is the case, then they should assess if the current regime to use sanctions against such settlement failures could be enhanced.

(3) Under what circumstances should measures apply to transactions carried out outside the European Union?

If a detected failure cannot be addressed at the EU level, it is advisable to use the well-established mechanisms, such as G20, IOSCO and FSB to achieve a globally consistent solution.

So far, it is unclear what failure requires addressing on an international scale. G20, IOSCO and FSB also provide a sounding board for ensuring that common grounds are reached, and help prevent individual jurisdictions to implement measures that might have damaging consequences for capital markets elsewhere.

[4] See response to Q1, summarizing some of the hypotheses by the Commission.

B: TRANSPARENCY

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

As long as it is unclear what exact issue/failure the regulators are seeking to address/detect, it is difficult to determine the exact scope of the regulatory disclosure regime. Given the amount of data regulators need to assess and collect, it might be practical to limit the scope of the data collection exercise to systemically relevant sectors, such as banking and insurance.

A useful approach might be to thoroughly assess how relevant the concerns are about market integrity and systemic stability before finalising the scope of the disclosure regulatory regime. This would also require a clearer definition of the issues/failures to be addressed.

(5) Under Option A is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?

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(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?

The HFSB has already made it clear that there is no justification for a public disclosure regime in its consultation response to CESR/09-581.[5]

(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?

The required notifications of regulators are a function of the actual failure:

So far, there has been no evidence that markets in EU sovereign debt do not function properly (market integrity perspective).

In terms of systemic concerns, excessive risk-taking by banks should be the primary focus, and risk management in banks (and regulation thereof) should take account of sovereign risk (or short positions in sovereign debt) along with many other sources of risk.

Systemic concerns emanating from sovereigns with excessive debt are best tackled at the source of the problem: prevention of excessive government debt. It is unclear how regulating the market (which merely reflects concerns about default/restructuring) would alter the systemic risks emanating from a sovereign default in the Eurozone or elsewhere. Today, more than ever, Europe needs investors with a sufficient appetite for (sovereign) risk to buy or hold on to their European government debts. Measures should, therefore, focus on making EU capital/sovereign bond markets more attractive to such investors.

The HFSB has already made it clear that there is no justification for a public disclosure regime in its consultation response to CESR/09-581. It is doubtful that public notification regimes will be

[5] http://www.hfsb.org/sites/10109/files/consultation_response_to_cesr_proposal_for_a_pan_european_short_selling_disclosure_regime_final.pdf

perceived as an enhancement of market quality and are unlikely to help attract more investors/market participants.

(8) Do you agree with the methods of notification and disclosure suggested?

In general, the proposed data template for notifications appears reasonable.

(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.

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

Beyond the direct cost (administration, systems, …) the more important concern relates to a potential deterioration of market quality. When the short selling restrictions were introduced in 2008, volatility and transaction costs significantly increased; i.e. capital markets will become more expensive as a source of finance. In light of simultaneous measures to reduce risk-taking by banks and potential bank levies, it is obvious that all sources of finance in the EU will become more costly.

Therefore, it is advisable that the European Commission assesses not only the short selling restrictions, but also the entire package of all regulatory measures currently reviewed to determine the cost benefit of each measure and its overall impact on the EU economies and economic growth.

C: UNCOVERED SHORT SALES

(11) What are the risks of uncovered short selling and what is the evidence of those risks?

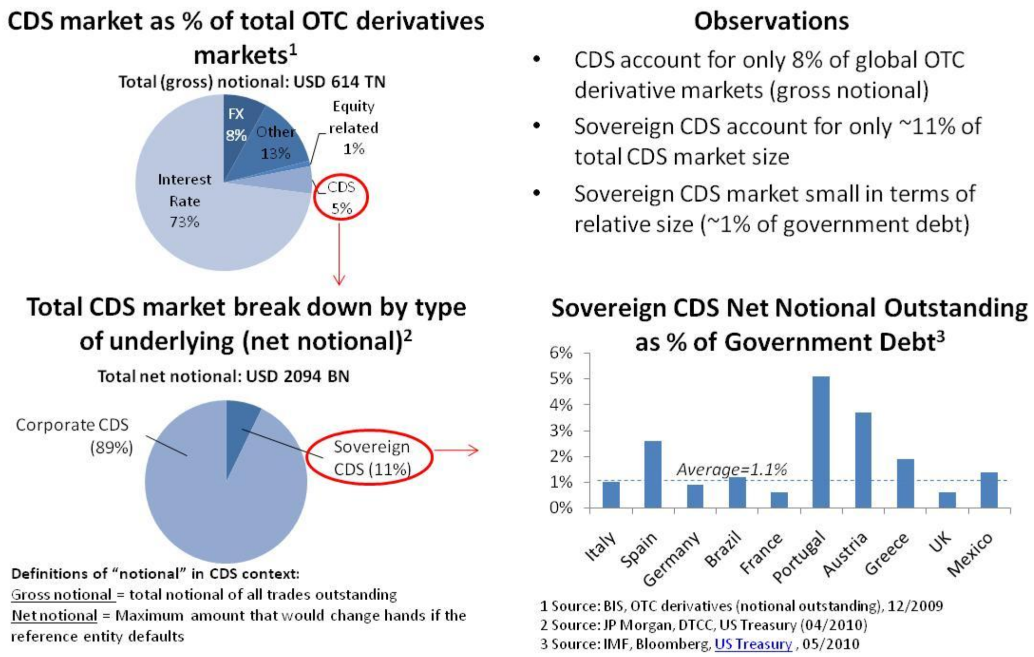
Securities:

The key risk arising from uncovered short selling are settlement failures (i.e. the underlying securities cannot be delivered in time). However, there is no evidence of significant failure in this area (i.e. large amounts of unsettled trades/failures).

"Naked CDS":

In contrast to many other derivative markets (e.g. in the commodities arena) the sovereign CDS markets are comparatively small in relation to the size of the underlying government bond markets (see Illustration 1).

Illustration 1: CDS are a small part of overall OTC derivatives and volumes are low in relation to sovereign debt



In the recent past, there have been allegations that CDS markets are used to "manipulate" underlying bond markets, but evidence suggests that CDS spreads are not a leading indicator, but rather a coincident indicator (see Illustration 2).

Illustration 2: Correlation of weekly spread changes since January 2009[1]

	CDS leading cash by 1 week	CDS coincident with cash	CDS lagging cash by 1 week
Portugal	11%	**71%**	7%
Italy	-7%	**51%**	-7%
Ireland	-8%	**69%**	0%
Greece	-4%	**83%**	-4%
Spain	-8%	**58%**	-13%

1 Source: US Treasury (IMF, DTCC) Spreads computed versus German Bunds

In a summary, there is no evidence of market integrity and systemic concerns in relation to (naked) CDS.

(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?

The HFSB is not aware of any such evidence.

(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?

The HFSB believes that the focus should be on ensuring proper settlement.

(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 no evidence of such risks. An upfront / permanent ban would be very detrimental to the quality of the European capital markets. It will restrict justified risk management activity and could result in some investors completely withdrawing from the market place.

(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)? (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.

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There should be no ban or limitation on naked credit default swaps relating to EU sovereign issuers. The more information (both buyers and sellers) finds its way into the price formation in the market, the more reliable the determined price will be. Excluding market participants who wish to express a pessimistic view would lead to further mispricing of assets. Banning naked short selling might also result in other investors leaving the market for fear of buying overpriced assets. As a result, liquidity will drop, and funding cost will rise, which is obviously not in the interests of European governments.

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

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

The HFSB would recommend that the Commission initiates a thorough assessment of the failures in capital markets in relation to short selling/naked short selling/CDS to determine whether the listed initiatives have any material positive impact. Also, the Commission should carefully assess issues in relation to market liquidity, investor confidence and implications for funding cost.

D: EXEMPTIONS

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

Yes.

(20) Do we need any exemption where the principal market for a share is outside the European Union? Are any other special rules needed with regard to operators or markets outside the European Union?

Given the global nature of markets and the ease of circumvention of national rules for international investors, it might be helpful to seek a consistent approach at the G20 level and involve IOSCO/FSB as a sounding board for the proposed measures.

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

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E: Emergency powers of competent authorities

(22) Should the conditions for use of emergency powers be further defined?

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

The Commission should carefully review potential follow on/second order effects of emergency measures, which could damage markets and investor confidence. Also, any emergency measure should be anchored within a rigorous assessment framework, to ensure that such measures are only used when there is solid evidence that the intended measures address the respective failure.

(24) Should the restrictions be limited in time as suggested above?

Yes, restrictions should be limited in time.

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

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(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.

(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.

F: Powers of Competent Authorities

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

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(29) What co-operation powers should be foreseen for ESMA on an ongoing-basis?

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