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EUROPEAN COMMISSION

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**COMMISSION STAFF WORKING DOCUMENT**

**SUMMARY OF THE IMPACT ASSESSMENT**

*Accompanying document to the*

Proposal for a

**REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL**

**on Short Selling and certain aspects of Credit Default Swaps**

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## **1. PROBLEM DEFINITION**

At the height of the financial crisis in autumn 2008, competent authorities in the United States and several EU Member States adopted exceptional measures to restrict or ban short selling in some or all shares. They acted due to concerns that at a time of considerable financial instability, short selling was aggravating the downward spiral in the prices of shares, notably in financial institutions, in a way which could ultimately threaten their viability and create systemic risks. The measures adopted by Member States were divergent as the European Union lacks a specific legislative framework for dealing with short selling issues.

In March 2010, concerns were expressed by some governments also about the possible role played by derivative transactions, notably Credit Default Swaps (CDS), in relation to the prices for Greek sovereign bonds. A number of Member States have adopted temporary or permanent restrictions at national level on short selling and CDS.

Short selling is the sale of a security that the seller does not own, with the intention of buying back an identical security at a later point in time to be able to deliver the security. It can be divided into two types: "covered" short selling where the seller has made arrangements to borrow the securities before the sale and "naked" short selling where the seller has not borrowed the securities when the short sale occurs. In addition to short selling on cash markets, a net short position can also be achieved by the use of derivatives, whether they are traded on exchanges or over-the-counter (OTC).

A Credit Default Swap (CDS) is a derivative which acts as a form of insurance against the risk of credit default of a corporate or a government. In return for an annual premium, the buyer of a CDS is protected against the risk of default of a given reference entity by the seller. If the reference entity defaults, the protection seller pays the buyer the par value of the instrument in exchange for physical delivery of the reference instrument, although settlement may also be by cash.

### **1.1. Risk of negative price spirals**

Short selling can lead to more efficient price formation by preventing the prices of securities from reflecting only the views of the most optimistic investors. However, especially in distressed markets when financial confidence is lacking, there is a risk of short selling creating the impression that there is more supply on the market than there really is, and thereby inciting others to sell ('herding behaviour'). This can lead to excessive downward pressure on the price of securities. The risk of negative price spirals becoming self-fulfilling, which can lead to disorderly markets and even systemic risks, is the main concern of regulators with regard to short selling.

In addition to short selling on cash markets, derivative transactions such as CDS can also be used to secure an economic short position. Buying a CDS without holding an underlying insurable interest ('naked CDS') is economically equivalent to short selling a bond, as the buyer benefits if the price of the CDS goes up. Several governments and regulators in Europe have expressed concerns with regard to CDS

and their interaction with bond markets, and the fear that this could cause mispricing on bond markets and thus higher funding costs for governments.

## **1.2. Risk of settlement failure associated with naked short selling**

The risk of the short seller failing to deliver the shares to the buyer by the settlement date, as well as a risk of increased price volatility, are the main risks associated by some regulators with naked short selling. Data on settlement failures is very limited, but suggests low levels in Europe. A majority of regulators said either that they have little experience of naked short selling or of related settlement problems, or that the risks were limited and could be addressed by settlement discipline. However, some regulators do perceive a risk of settlement failure, as well as a greater risk of increased price volatility, with naked short selling which should be addressed. These regulators expressed concern that in extreme cases naked short selling can put enormous pressure on share prices, which can endanger the stability of the financial system. This is because naked short selling enables the seller to sell, in principle, an unlimited number of shares in a very short space of time as they do not have to first borrow or locate the shares.

## **1.3. Transparency deficiencies**

In most EU Member States there are currently no disclosure requirements for short selling or CDS transactions, so these Member States have no direct access to data on the short positions held in their jurisdictions; although as a result of the financial crisis, a number of Member States have introduced different short selling disclosure requirements. Regulators have expressed concern that this situation makes it difficult for them to detect the build-up of positions which could have implications for the stability of markets. Disclosure to the regulator could help regulators to identify when this is occurring, and deter aggressive strategies which could contribute to disorderly markets.

There is also a risk of information asymmetries between informed short sellers and other less informed market participants. Disclosure to the market provides information to other market participants about the price movements which short sellers expect and this could improve the efficiency of price discovery. Transparency to the market would also ensure that more information about the opinions that investors hold on a particular security would be made available to all investors

Concern has also been expressed by some regulators that speculators may be driving down the prices of government bonds by using Credit Default Swaps (CDS). The concern of these regulators is that in the absence of information about sovereign derivative and bond transactions it is more difficult for them to detect the build-up of positions which could cause financial instability, as well as possible market abuse.

## **1.4. Regulatory arbitrage and increased compliance costs**

The fragmented responses of Member States to issues relating to short selling leave scope for regulatory arbitrage, as investors could seek to circumvent restrictions in one jurisdiction by carrying out transactions in another. This regulatory fragmentation could also lead to increased compliance costs for market participants, especially those operating on several markets, who would have to set up different systems to comply with different requirements in different Member States.

## 2. THE BASELINE SCENARIO AND SUBSIDIARITY

If no action is taken at EU level the problems defined above are likely to remain without a coordinated response and to occur again in the future. The European Commission considers that the solutions proposed respect the principle of subsidiarity. First, because there is a real risk of national responses to short selling and CDS being circumvented or ineffective in the absence of EU level action. Second, such uncoordinated measures are also more costly to market participants. Finally, certain aspects of this issue are already partly covered by the *acquis*, notably: the Market Abuse Directive, the Transparency Directive, and the Markets in Financial Instruments Directive. Therefore a proposal on short selling and these existing legal instruments should complement each other.

## 3. OBJECTIVES

In light of the analysis of the risks and problems above, the general objectives of the legislative proposal on short selling are to reduce the risks to financial stability, systemic risks and risks to market integrity arising from short selling and to prevent market fragmentation, thereby increasing the efficiency of the internal market. .

Reaching these general objectives requires the realisation of the following more specific policy objectives:

- (1) Reduce the risks of negative price spirals arising from short positions (including those obtained through CDS)
- (2) Increase the transparency of short positions (including those obtained through CDS);
- (3) Reduce settlement risk linked with 'naked' short selling; and
- (4) Reduce the scope for regulatory arbitrage and compliance costs.

## 4. POLICY OPTIONS

The policy options are grouped according to the operational objectives which flow from the above-mentioned specific objectives.

### 4.1. Policy options to ensure regulators have clear power to restrict or ban short selling or CDS in distressed markets

- (1) Option 1 – take no action at EU level.
- (2) Option 2 – introduce a power for national competent authorities to temporarily restrict short selling in a financial instrument admitted to trading on an organised market whose price has fallen by a specified quantitative threshold, e.g. 10% ('circuit breaker').
- (3) Option 3 – introduce a rule that prohibits short selling of a financial instrument admitted to trading on an organised market except at a price above

the last traded price of the instrument, or at the last traded price if that price was higher than the price in the previous trade (an 'uptick rule').

- (4) Option 4 - introduce a ban on 'naked CDS' (i.e. entering into a CDS contract without having an underlying insurable interest). Compatible with 2 and 3.
- (5) Option 5 – grant national competent authorities the power to temporarily restrict or ban short selling of some or all financial instruments or CDS transactions in exceptional situations, with coordination by ESMA in accordance with article 6a(5) of Regulation ??/EC establishing ESMA, and without prejudice to ESMA's powers under article 10 of this Regulation. Compatible with 2, 3 and 4.
- (6) Option 6 – introduce a permanent ban on short selling of all financial instruments capable of being sold short. Compatible with 4.
- (7) Option 7 - introduce permanent restrictions or ban on CDS. Compatible with 2, 3 and 6.

#### **4.2. Policy options to ensure regulators and markets obtain data on short positions (including through CDS).**

- (1) Option 1 - take no action at EU level
- (2) Option 2 - introduce a system of flagging of short sale transactions so that regulators can identify which transactions are 'long' and which are 'short'.
- (3) Option 3 - notification of short positions to the regulator. Compatible with 2.
- (4) Option 4 - disclosure of short positions to the public. Compatible with 2 and 3.
- (5) Option 5 - aggregated disclosure of short positions (i.e. individual short positions of investors are not disclosed). Compatible with 2, 3 and 4.
- (6) Option 6 - disclosure of individual significant net short positions. Compatible with 2, 3 and 4.
- (7) Option 7 - exemption from disclosure requirements for market making activities and certain primary market operations. Compatible with 2-6.

#### **4.3. Policy options to ensure certain requirements at the point of trading and strengthen settlement discipline**

- (1) Option 1 - take no action at EU level.
- (2) Option 2 - introduce a requirement that before entering into a short sale, a person must have borrowed the share, entered into an agreement to borrow the share or have other arrangements which ensure that he will be able to borrow the share at the time of settlement (locate rule)
- (3) Option 3 – introduce EU rules on settlement discipline so that persons engaging in short sales which result in a failure to deliver face appropriate

penalties, with buy-in procedures and fines in case of settlement failures. Compatible with 2.

- (4) Option 4 - introduce a ban on naked short selling
- (5) Option 5 - exemption for market making activities and certain primary market operations. Compatible with 2, 3 and 4.

#### **4.4. Policy options to ensure a coordinated response by EU member states to short selling and CDS**

This objective should be met by the above three categories of targeted options. In addition, the choice of legal instrument should also aim to ensure coordinated national responses.

### **5. ASSESSMENT AND COMPARISON OF THE OPTIONS**

The different policy options were tested against the criteria of their effectiveness and efficiency in achieving the related objectives. The comparison of policy options lead to the following conclusions:

- *Clear powers*: the preferred option is a combination of option 5 (emergency powers), and option 2 (circuit breaker). A combination of the two options would give regulators an instrument to impose a short term ban on short selling on organised markets in the event of a significant price decline as well as the possibility to impose a temporary ban of a longer duration, capturing derivatives as well, in the event of an exceptional situation.
- *Transparency*: the preferred option is a combination of options 2, 3, 4, 6 and 7. By combining options 3 and 4, the objective of transparency for both regulators and the market would be achieved fully. In addition, a higher threshold for notification to the market would mitigate any impact on liquidity, while ensuring that regulators obtain the data they require. Option 6 (individual disclosure) should also be part of the preferred option, as it meets the objectives more fully by providing the market with more detailed transparency. Option 2 (flagging) would complement disclosure very effectively by providing regulators with real time data on all short positions, thereby capturing intraday positions and helping regulators with enforcement. Finally, option 7 (market making and primary market operations exemption) would ensure that the important liquidity provision function of these activities would be able to continue, which would mitigate any potential impact on liquidity of disclosure.
- *Settlement discipline*: the preferred option is a combination of options 2, 3 and 5. If options 2 and 3 were combined, settlement discipline would be reinforced both by requirements at the point of trading and by buy-in procedures and fines, thereby meeting very effectively the related operational objective. By combining option 5 with options 2 and 3, the potential negative impact on liquidity would be mitigated by a harmonised exemption for market making, and so would the potential for regulatory arbitrage and compliance costs associated with different exemptions across the EU.

- *Coordinated response*: non-legislative cooperation is discarded because it would not provide an effective solution to uncoordinated national actions leaving scope for regulatory arbitrage and higher compliance costs. A Regulation should be preferred to a Directive as it is immediately applicable, would ensure uniform rules throughout the EU and those concerned by its provisions would be able to depend on them immediately.

## 6. IMPACTS OF THE PREFERRED OPTIONS

	Impact on stakeholders	Effectiveness	Efficiency
<b>Options 2 + 5 (circuit breaker and powers in exceptional situations)</b>	(+++) regulators gain powers to ban short selling/CDS in exceptional situations and short term (+++) issuers' share price can be supported by a temporary ban on short selling in distressed markets (0) governments: reduced volatility on sovereign bond markets, but risk of negative effects on liquidity (- -) financial institutions may be temporarily restricted from short selling & face compliance costs	(+++) achieves objective 1 fully (+++) Objective 4: fully met (+++) avoids unduly negative effects on market efficiency	(-) reduced compliance costs due to coordinated EU approach; any effect on liquidity temporary
<b>Options 2+ 3 + 4 +6 + 7 (flagging, notification to regulator and disclosure to market of individual net short positions, with exemption for market makers and primary market dealers)</b>	(+++) regulators: full transparency on short positions (+++) issuers: access to data on significant short positions and full benefit of liquidity provided by market makers (+++) individual investors: information asymmetries eliminated and liquidity provided by market makers maintained (+++) governments: liquidity in sovereign bonds not impaired (-) financial institutions: compliance costs and likely to reduce short selling to avoid disclosure to public, but can continue market making activities	(+++) Objective 2: fully met (+++) Objective 4: fully met (++) limits unduly negative effects on market efficiency	(-) ongoing compliance costs; impact on market liquidity mitigated by thresholds and exemption
<b>Options 2+3+5 (locate rule, and settlement discipline with exemption for market makers and primary market dealers)</b>	(+++) regulators can sanction naked short selling (+++) issuers: number of shares sold short cannot exceed the number issued or available to borrow, liquidity not impaired due to market maker exemption (+++) governments: number of government bonds sold short cannot exceed the number issued or available to borrow, liquidity not impaired due to market maker exemption (+ ) some financial institutions may have to adapt their compliance systems, but market making exempt	(++) Objective of reducing settlement risk achieved by rules at the point of trading and settlement discipline (+++) Objective 4: met in full (+) Contributes to reducing risk of negative price spirals	(-) some ongoing compliance costs although many already operate locate rule; impact on liquidity mitigated by market maker exemption

## 7. MONITORING AND EVALUATION

The Commission will monitor how Member States are applying the changes proposed in the legislative initiative on short selling. The evaluation of the legislative measure could take place three to five years after its entry into force, in the context of a report to the Council and the Parliament on the appropriateness of the reporting and public disclosure thresholds.