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Short selling: an increasing need for a global harmonisation

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The 2008 financial crisis led securities' regulators around the globe to limit or prohibit short selling, believing that it could lead to a collapse in securities' prices. However, although such measures were introduced almost simultaneously at national level (for a limited period of time), they lacked homogeneity as they had not been previously agreed upon at international level, with the consequence that their application created serious issues in the global financial markets.

In Europe, the patchwork adoption by national regulatory authorities (NRAs) of measures restricting or prohibiting short selling, in the absence of EU law harmonised rules, further destabilised the markets.

In light of the above, the need to define global legal standards on short selling is strongly perceived to be a worldwide issue, as it would avoid both:

- Unjustified disparity of treatment in cross-border financial transactions.
- Market participants having to comply with several sets of rules, with each of those sets of rules being applicable at national level.

Recently, the EU has promoted harmonisation in this field through:

- The involvement of the Committee of European Securities Regulators (CESR), which was replaced by the European Securities and Markets Authority (ESMA) on 1 January 2011.
- The introduction of Regulation (EU) no. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (Regulation), imposing the obligation to disclose short positions (that is, those in which the seller does not own the securities being sold, to be delivered to the buyer upon settlement), and granting ESMA the power to coordinate measures taken by NRAs, as well as to directly intervene in those cases where the financial stability of a single member state, or of the whole EU, is at stake.

SHORT SELLING: IS IT NEGATIVE OR POSITIVE?

Short selling is a financial transaction consisting of selling securities without either:

- Owning the securities.
- Having the securities available.

The securities are sold so that they can be bought at a later stage, at a lower price, for the purpose of profiting from the difference between the sale and the purchase price.

Short selling can be "covered" or "naked". In "covered" short selling, the seller borrows a number of securities equivalent to those which the seller itself intends to short-sell, in order to guarantee the delivery of the securities to the buyer upon settlement. Subsequently, the seller purchases an equivalent number of securities to remunerate the lender. In "naked" short selling, the seller has neither access to the securities being sold, nor has previously borrowed them. For this reason, in order to settle the transaction, the seller will purchase beforehand, on the market, the securities to be delivered to the buyer.

The practice of short selling can have different goals:

- **Speculative.** That is, realising a profit by selling short a security that is believed to be overvalued, and benefiting from the difference between the purchase and the sale price, due to a decline in market value of the security in question.
- **Arbitrage.** That is, simultaneously buying and selling interrelated securities, in order to take advantage of price misalignments.
- **Hedging.** That is, covering themselves against the risk of fluctuations in market variables.
- **Market manipulation.** That is, reducing the price of certain securities, spurring other operators to sell, which further lowers the price of those securities. The same securities are then purchased by a market manipulator (or a related party).

When it is done on a large scale, short selling can have a significant negative impact on financial markets' stability, causing securities' prices to fall rapidly and increasing volatility.

Notwithstanding the above, short selling can also have positive effects, by increasing liquidity and reducing the price of financial transactions, whilst enhancing the price transparency of securities' prices and facilitating hedging activities.

RECENT MEASURES ON SHORT SELLING AT EU AND INTERNATIONAL LEVEL

The measures taken against short selling by NRAs at the outset of the financial crisis of late 2008 lacked even the simplest coordination at international level.

In Europe, bans on short selling were first introduced in the UK, where the Financial Services Authority (FSA) on 18 September 2008 (and up until 16 January 2009) prohibited short selling, both naked and covered, on securities of financial companies. At the same time, the FSA also introduced the obligation to daily publish all net short positions higher than 0.25% of the stock

capital of a list of companies compiled by the FSA (the same requirement is still in place today). In addition, the FSA indefinitely extended the disclosure regime concerning significant net short positions in UK financial firms (although this was not done on a permanent basis, since any such provision would inevitably be either superseded by a worldwide disclosure regime, or revoked altogether).

In Germany, the Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) (BaFin) introduced, in September 2008, a ban on the naked short selling of shares of a predetermined group of financial firms, which terminated at the end of January 2010. It then imposed (in May 2010) a temporary short-sales ban on certain banking and insurance securities, as well as on the Eurozone government debt. However, the latter measure was strongly criticised, as it was adopted without any prior discussion with EU NRAs. BaFin also extended the ban on the short selling of listed securities (although there were some exceptions to this ban), and, in order to increase transparency, established that owners of net short positions amounting to 0.2% (or more) of the stock capital of predetermined financial firms operating in Germany must have previously communicated those positions to BaFin itself. In addition, where the positions held reached 0.5% (or more) of the capital of the above-mentioned firms, the holders of those positions must also disclose them to the public. It is worth pointing out that this disclosure regime only applies to the ordering party (whether or not German resident), while the intermediary executing the order is only required to prevent the illegal recourse to short selling by the ordering party.

In France, the Authority of Financial Markets (*Autorité des Marchés Financiers*) (AMF) initially introduced:

- The duty to communicate, both to the AMF and the market, net short positions of more than 0.25% held in the share capital of banking, financial or insurance companies.
- The prohibition of naked short selling.
- The limitation for brokers to lend securities, which had the effect of hindering covered short selling, without formally prohibiting it.

In relation to pure brokers (not providing for custody and administration services), the AMF clarified that obtaining a statement from the ordering party confirming that the latter owned the securities subject to the sale order was sufficient (for the brokers) in order to comply with the law. In October 2010, based on the CESR's indications, the AMF introduced a transparency regime for net short positions with regard to all issuers listed on the Euronext Paris and Alternext Paris markets. On 11 August 2011, the AMF (notably, in coordination with Belgian, Greek, Italian and Spanish NRAs) placed a ban (which was permanently lifted on 11 February 2012) on:

- The creation of net short positions by any person established or residing in France, or operating there without a branch.
- On the increase of existing equity positions (including intraday), giving access to the capital of certain credit institutions and insurance companies.

More interestingly, the sanctions recently issued by the AMF for breach of the short selling ban were addressed to the ordering party only, and not to the intermediary executing the sale order(s) (see, on this point, the AMF decision of 27 November 2008 in the "*Boussard et Gavaudan Gestion*" case).

In the US, the Securities and Exchange Commission (SEC) issued, in July 2008, a temporary ban on naked short selling with regard to the securities of 19 financial sector companies. As the crisis worsened in the Autumn of the same year, the ban was extended to covered short selling on securities of approximately 800 companies active in the financial sector. Subsequently, this measure was modified by both:

- Delegating to the stock exchanges' managing companies the definition of the list of banned securities.
- Exempting market makers from the ban.

On 24 February 2010, SEC restricted the short selling of securities whose price had declined by more than 10%. Under the Dodd-Frank Act, SEC has been requested to report to the US Congress on the feasibility, benefits and costs of two alternative disclosure regimes, which would involve the real-time reporting of net short positions either to the public or to the SEC only. A report on the matter should be released by the end of June 2012. Another report to the US Congress, on the state of short selling on exchanges and in the over-the-counter markets, is expected to be issued by SEC by the end of December 2012. In addition, the deadline for adopting rules regarding the public disclosure of information concerning short sales, which will implement the short sale reforms under the Dodd-Frank Act, to date unfixed.

In China, in stark contrast to the response from the rest of the world, the China Securities Regulatory Commission (CSRC) announced (on 5 October 2008) the commencement of a liberalisation project that authorised certain types of transactions that had previously been prohibited. Short selling was among the transactions that was authorised as a result. On 22 January 2010, the CSRC adopted further measures allowing financial operators holding specific features to carry out short selling transactions.

SHORT SELLING REGULATION: FOCUS ON ITALY

At the same time as the other NRAs, in the Autumn of 2008 the Italian Commission for the Securities and Exchange (*Commissione Italiana per le Società e la Borsa*) (Consob) limited and, in specific cases, prohibited the short selling of securities traded on the Italian regulated markets.

On 22 September 2008, Consob banned the short selling of securities of banks and insurance companies listed and traded on the Italian regulated markets, where those securities were not available to the seller from placing the order through to its delivery of the securities. On 1 October 2008, Consob expanded the prohibition's scope by resolving that sales of securities of these companies must be supported not only by their availability, but also by the seller's ownership of the securities. On 10 October 2008 the ban was extended (initially up to the end of December 2008) to encompass all securities listed and traded on the Italian regulated markets. On 30 December 2008, the ban was confirmed, but only in relation to securities of banks and insurance firms or of companies under capital increase. From that date, for all other types of listed securities, the ban applied only to sales not supported by the availability of the securities being sold.

A few months later, the scope of the ban was modified again, by prohibiting short sales of all financial instruments not supported by the availability of the financial instruments from placing the related sale order up to the settlement date (*Consob Resolution of 27 May 2009*, which entered into force on 1 June 2009). This did not apply to companies under capital increase, where the ordering party was required to have both the availability and ownership of the instrument subject to the sale. By means of subsequent Resolutions (adopted on 28 July 2009, 14 October 2009 and 26 November 2009, respectively), Consob confirmed the prohibition of short sales only with regard to shares of companies under capital increase, where those shares are not available to and owned by the seller from placing the order and through to the relevant settlement date.

During proceedings brought by intermediaries against Consob's sanctions imposed on them for alleged breaches of the ban on short selling, Consob, unlike other European NRAs in similar proceedings (for example, the AMF), has taken the view that brokers must comply with a duty of diligence, and should autonomously verify, on receiving a sale order, the availability and ownership of the securities being sold. This verification should be obtained by an ad hoc declaration to that effect from either the:

- Ordering party.
- Securities' custodian.

Consob has focussed its attention on the interested intermediary's duty to check, before executing the order, whether or not the seller has the availability and ownership of the securities that are subject to the sale order. This duty of diligence, for Consob, is the crux of the matter as far as compliance is concerned, rather than demonstrating whether or not a short sale exists.

Under the relevant Italian case law, which has seen some recent developments in this area (*see Court of Appeal of Milan, Decision of 1 April 2011, and Administrative Court of Lazio, Decision of 9 May 2011, No. 03934*), in executing sale orders, brokers can claim to have fulfilled their duty of diligence by obtaining, before executing a sale order, a declaration from the ordering party (or from its custodian) confirming that it owns and has available the securities subject to the sale.

It is not sufficient for intermediaries, before executing a sale order, to merely ensure that the ordering party is aware of the existence of a ban on short selling. Moreover, it is part of the intermediaries' duty of diligence to decide what actions should be taken for each individual sale order, and assess what measures are appropriate, given the particular circumstances of each case, to ensure that the ban on short selling is complied with.

For instance, where the intermediary suspects that a transaction which has as its subject a sale of a sizeable amount does involve short selling, it must comply with a duty of diligence and verify that the seller has the availability and ownership of the securities subject to the sale order.

Furthermore, intermediaries cannot justify their conduct with regard to short sales merely on the basis of the fact that they acted on their clients' instruction. On this point, the Court of Appeal of Milan and the Court of Appeal of Brescia (through Decisions of 7 October 2009 and 12 May 2010, respectively) clarified that the degree of diligence to be observed when providing their services is the same as the degree of professionalism and high level of experience that is required of them when acting for their clients.

The disclosure regime concerning net short positions was introduced by Consob on 10 July 2011 (in agreement with certain other EU NRAs). Under this regime, listed companies must report to Consob any net short position reaching or surpassing certain thresholds (initially equal to or above 0.2% of the issuer's stock capital, and then for any further variations of 0.1% or more of the same stock capital).

On 12 August 2011, Consob prohibited the taking of any new net short positions and the increasing of any existing ones (including intraday) concerning the share capital of financial firms. The underlying aim of this prohibition was to reduce the financial market's volatility, which the reporting obligations on their own had failed to do. Consob extended this ban up to 24 February 2012, irrespective of the recommendations of the intermediaries' national association (Assosim). Indeed, Assosim pointed out the need to limit the prohibition to a shorter period of time, since the prohibition itself would not prevent a drop in share prices. On 24 February 2012 Consob lifted the ban, though its other measures have not been repealed, and the following remain in place:

- The obligation to disclose significant short positions (above 0.2% of the share capital) issued in relation to shares on Italian regulated markets.
- The prohibition of "naked" short sales.

Consob has announced that these measures have not been repealed because they substantially anticipate the coming into force of the Regulation, which is expected by 1 November 2012.

THE NEW EU REGULATION ON SHORT SELLING

The need for an integrated EU approach to measures concerning short selling has been increasingly felt by NRAs within the EU, particularly over the last few years.

In this respect, in July 2009 CESR launched a consultation procedure on a proposal for a EU-wide disclosure regime, consisting of a two-tier approach based on a lower and a higher threshold, as follows:

- 0.2% net short positions in all shares admitted to trading on an European Economic Area (EEA) regulated market and/or an EEA multilateral trading facility (MTF) (when the primary market is located in the EEA) should be disclosed to the relevant NRA.
- 0.5% positions (as well as any additional positions equal to 0.1% or more) should also be disclosed to the market as a whole.

In response to the CESR consultation, on 15 September 2010 the EU Commission (Commission) adopted a proposal for regulating short selling and credit default swaps aimed at:

- Ensuring the efficient monitoring of financial markets.
- Imposing a ban on naked short selling.
- Permitting covered sales only where those sales have as their subject financial instruments previously borrowed, where the ordering party has an agreement to borrow the securities, or where it is reasonable that the securities will be settled upon the agreed settlement date).

To promote effective coordination among NRAs, the Commission's proposal identified ESMA as the EU authority that must:

- Ensure that cross-border transactions receive the same treatment in all the interested EU member states.
- Issue mandatory technical standards.
- Coordinate the activities at EU level.
- Review the necessity and proportionality of the measures taken by NRAs against financial crises.
- Directly intervene, by temporarily prohibiting or limiting short selling, should there be a threat to EU financial markets, where the measures adopted by NRAs are not appropriate to offset ongoing crises (this is perhaps ESMA's most significant power).

It is important to note that, in the event of a conflict, the measures adopted by ESMA will prevail over those issued by individual NRAs.

In light of the above, on 15 November 2011 the European Parliament officially adopted the Regulation, based on the text of the Commission's proposal, as further amended on 5 July 2011. The main purpose of the Regulation is to enhance transparency on net short positions and bring to an end the fragmented measures that have been adopted, over the course of time, by individual member states in this area. In that context, on 24 November 2011 the Commission requested that ESMA delivers, by 31 March 2012, its technical advice on possible delegated (non-legislative) Acts of general application concerning technical issues that follow from the Regulation.

Finally, it is worth highlighting the fact that some of the aims of the Regulation have already been achieved, since many EU NRAs have already adopted similar measures to those contained in the Regulation.

CONCLUSIONS

The measures that have so far been adopted concerning short selling have had several goals:

- Limiting sudden drops in share prices.
- Allowing a more orderly price formation process.
- Preventing illegal practices.

However, in order to be effective it is suggested that short selling regimes need to be harmonised across the globe, in a manner that takes into account both the positive and negative effects of short selling. These measures should therefore not be limited to a simple prohibition on short sales, since this in itself may lead to artificial price distortions that are capable of harming the financial markets' integrity.

The Regulation is an important step in this direction, particularly since it not only entrusts ESMA with the power to coordinate NRAs, but also to directly intervene in certain circumstances. This tentative step towards EU harmonisation should also be considered at international level, to ensure that the management of future financial crises is not left solely to the whims of individual NRAs.

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- Assisting a global investment firm in proceedings against Consob before the competent Italian courts for alleged breach of measures on short selling, and against the Italian Stock Exchange's managing company for alleged breach of rules of conduct concerning the regular settlement of contracts.
- Advising the Italian branch of a worldwide private bank in updating the contractual platforms in light of recently enacted Italian laws and regulations (implementing MiFID, transparency and anti-money laundering legislation).

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