Financial market policy after the crisis – short selling and the global regulatory environment

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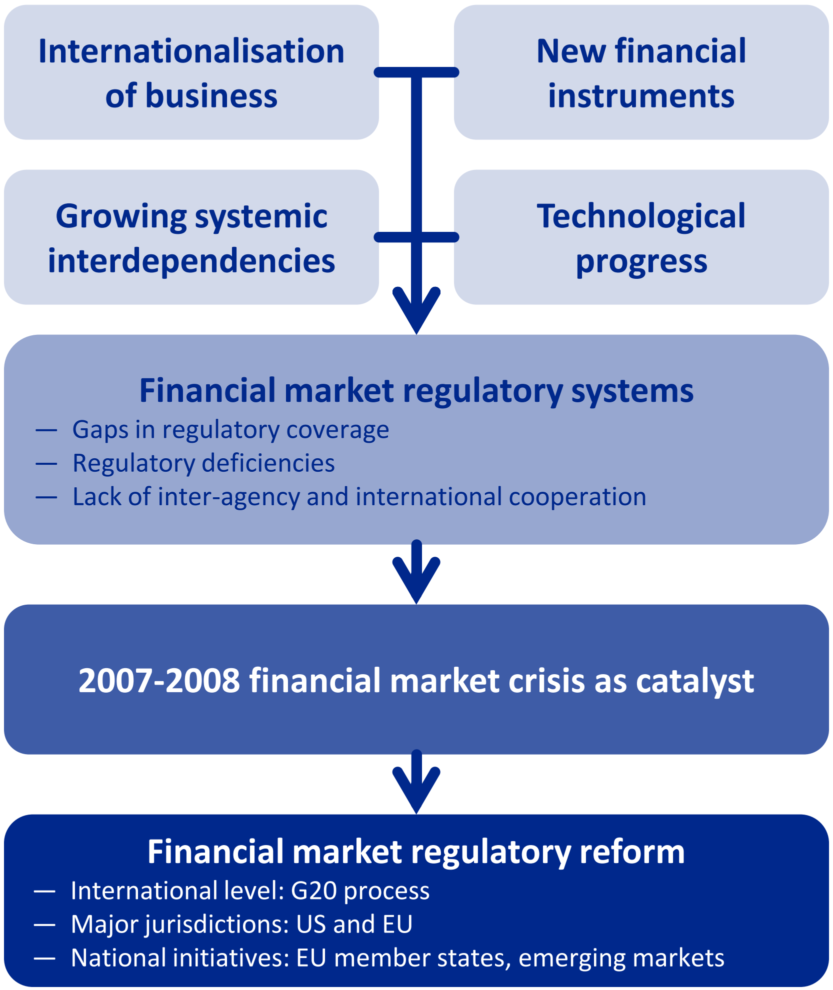
Regulatory reform on the agendas of US, EU, and beyond – coincidence of economic and political forces

- **Deficient risk management in financial sector as root cause of crisis**
  - — Private sector initiatives to improve risk and liquidity management
- **Financial crisis also highlighted shortcomings in existing regulatory and supervisory systems**
  - — Gaps in coverage of regulation
  - — Regulatory deficiencies
  - — Lack of cooperation among supervisors – within individual countries and cross-border
- **Financial market development and globalisation had caused pressure on regulatory reform to mount – even before the crisis**
  - — New financial instruments and market practices
  - — Internationalisation of business



The financial crisis – Global regulatory responses

- **Substantial reform of regulatory and supervisory arrangements agreed at G20 level**
- **Supervision and regulation**
  - Build stronger, globally consistent framework
  - Identify macro-prudential risks
  - Extend regulation to all systemically important financial institutions, instruments and markets (incl. HFs)
  - Improve quality, quantity of bank capital
  - Action against non-cooperative jurisdictions, incl. tax havens
  - Single set of high-quality global accounting standards
  - Extend regulatory oversight and registration to CRAs

US (Dodd Bill)

- Institutional reform – creation of FSOC (Financial Services Oversight Council), redesign of banking supervision, creation of consumer protection authority, revamping authority of Fed
- Regulation of systemic risk
- Activity restrictions on major banks
- Special resolution authority for systemically significant institutions
- Regulation of OTC derivatives
- Securitization
- Oversight of “shadow banking”
- Regulation of CRAs, insurance, broker dealers, C&S
- Executive compensation and corporate governance

EU

- Institutional reform – creation of ESRB, ESFS, ESMA, EBA, EIOPA
- Alternative investments (AIFM)
- Derivatives trading, CCPs
- Capital requirements (CRD reform)
- Short selling (CESR proposals)
- Banking levy and resolution (Commission proposals)

US and EU regulatory approaches – Key features

	US	EU
Institutional priorities		
Fundamental changes to existing institutional arrangements	✗	✗
Evolutionary approach with moderate additions, deletions, and changes	✓	✓
Systematic consolidation of banking, securities, insurance supervisors	✗	✗
Top-level inter-agency cooperation on macro-prudential issues	✓	✓
Streamlining of international institutional framework	✗	✗
Regulatory priorities		
Getting a grip on macro-prudential oversight	✓	✓
Extension of coverage of regulation to previously unregulated markets	✓	✓
Tightening micro-prudential rules	✓	✓
Strengthening of consumer and investor protection	✓	✗
Far-reaching regulatory reform, establishment of unified rule-books	✗	✗
Effective, principles-based regulation	○	○

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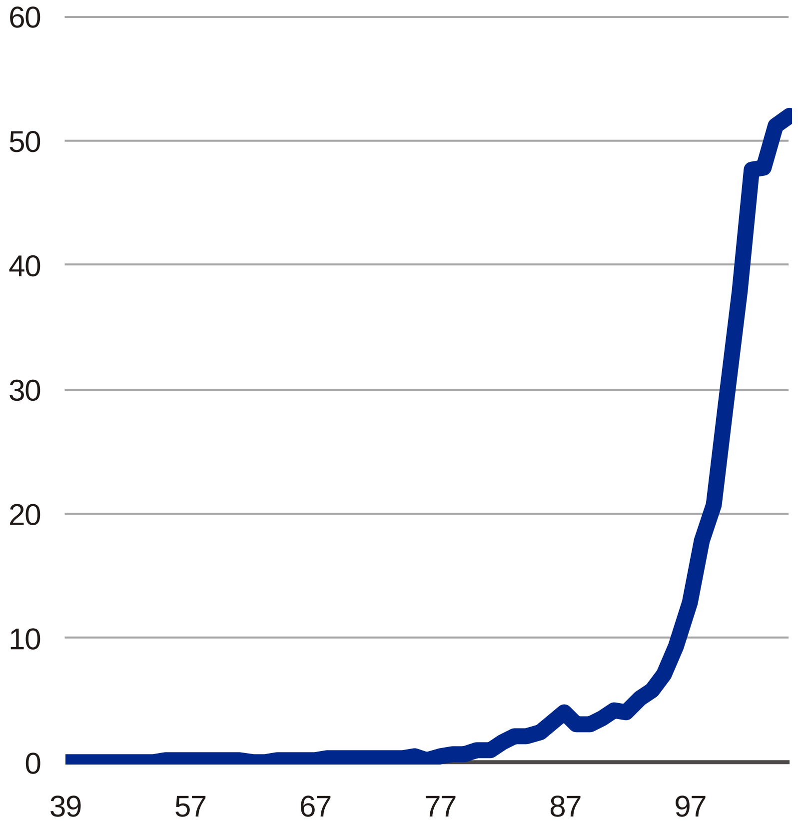
The rise of short selling – dramatic growth

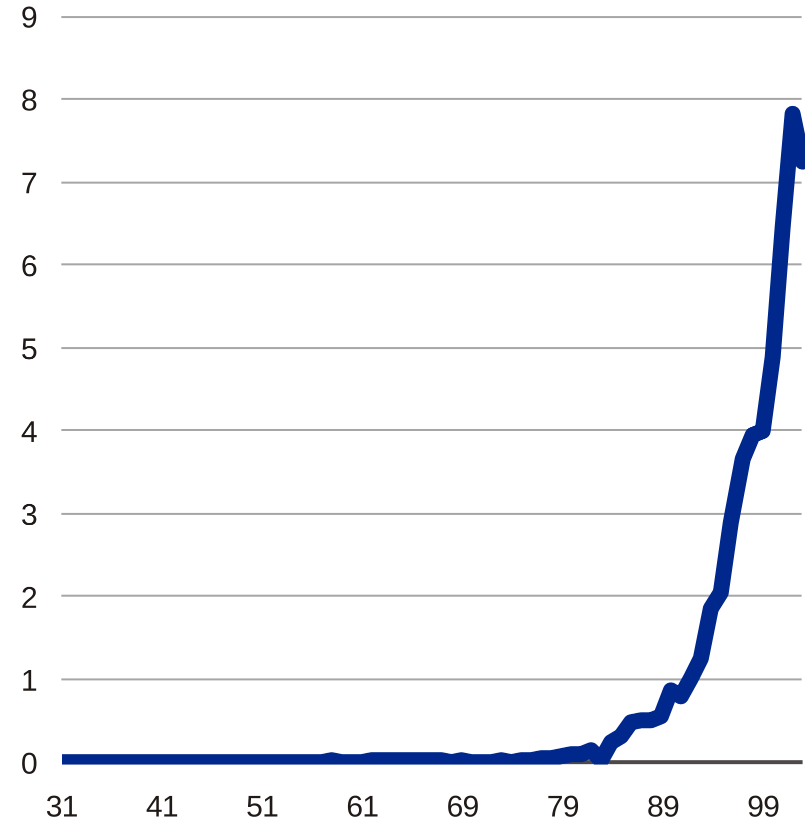
Number of shares sold short

Short selling at the NYSE, as measured by number of shares sold short, bn shares per year



Short interest

Short selling at the NYSE, as measured by short interest, i.e. the number of shares of a publicly listed company sold short at year end, bn shares outstanding



Sources of political discomfort – market disruptions and pressure on sovereign issuers

Risk of market disruptions

Volkswagen short squeeze, share price Volkswagen AG, daily figures, EUR

Threat of government default

5Y CDS spreads, bps

Benefits of short selling greater than drawbacks

Potential benefits	Potential drawbacks
Efficient price discovery ► Market participants selling assets contribute important information to the market – irrespective of whether they owned the asset in the first place ► May belong to the first to identify fundamentally unjustified price developments	**Market disorder** ► Re-pricing of assets is feared to occur in disorderly manner, leading to overshooting ► Not specific to short selling
Higher market liquidity ► As counterparts to buyers they facilitate trading transactions that otherwise may not materialise	**Market abuse** ► Short selling feared to be used in conjunction with abusive market practices, e.g. insider dealing ► Not specific to short selling
Better hedging and risk management ► Enables investors to manage exposures to assets that they own, but which they are not in a position to sell when they expect prices to fall	**Settlement disruptions** ► Short selling disruption when seller fails to deliver borrowed assets ► In extremis, failure to locate assets ► Esp. naked short selling

Regulatory options – transparency and control

Disclosure requirements

Typical regulatory characteristics
- ► Disclosure by sellers or broker-dealers of short positions or individual transactions
- ► Trigger thresholds between 0.1% and 0.5% of outstanding issued stock
- ► Objective: Provide supervisory authorities and markets with overview of shorting activities, impose incentives on market participants

Key issues
- ► Short positions vs. individual transactions
- ► Gross vs. net figures
- ► Level of trigger threshold
- ► Regulatory vs. public disclosure
- ► Reporting time or period

Practising jurisdictions
- ► US
- ► HK
- ► JP
- ► EU (drafting stage), DE, FR, UK

Short selling restrictions

Typical regulatory characteristics
- ► Prohibition of short selling or specific market practices, esp. naked short selling
- ► Trigger thresholds with view to price declines in the underlying asset (circuit breakers)
- ► Penalties on failure to deliver
- ► Uptick rules: Short sales only permitted if above current best bed

Key issues
- ► Level of trigger threshold
- ► Extend of market practices covered
- ► Level of penalties
- ► Design of uptick rules

Practising jurisdictions
- ► US
- ► HK
- ► SG
- ► JP

Regulatory practice – divergence of national rules

Inter-national

IOSCO

- ► **Appropriate controls to address the risks to an orderly and efficient functioning of markets and to financial stability**
- ► **Reporting regime that provides timely data to markets and authorities**
- ► **Effective compliance and enforcement systems**
- ► **Appropriate exceptions for certain types of transactions**

National

US	EU (draft)	DE, FR, UK	HK	SG
► **Disclosure**: Regulatory and public disclosure of all transactions from 0.25% of outstanding ► **Restrictions**: Circuit breaker and Alternative Uptick Rule	► **Disclosure**: Regulatory and public disclosure of net short positions creating economic exposure based on tiered thresholds ► **Restrictions**: None. CESR examines need for restrictions.	► **Disclosure**: Disclosure rules in line with draft CESR requirements ► **Restrictions**: None.	► **Disclosure**: Regulatory disclosure of all transactions ► **Restrictions**: Naked short selling prohibited, covered short selling limited to specified securities	► **Disclosure**: No requirements ► **Restrictions**: Naked short selling partially prohibited, penalties on failed trades

Regulating short selling – the economist's view

Short selling	► In principle, nothing wrong with short selling – promotes efficiency of functioning markets.
Naked short selling	► Naked short selling can facilitate disruptions (squeeze) with significant price effects. ► Limiting naked short selling will not prevent drastic price declines of troubled assets. ► Rather, a ban of naked short selling eliminates important early warning indicator for mispriced assets and market bubbles.
Market abuse	► Short selling can be used by market abusers just like any other financial instrument. ► Short selling should therefore be subject to the same strict regulatory provisions, as is generally the case already.
Regula-tion	► **Disclosure**: No principal objections against disclosure of short selling to regulators. ► **Restrictions**: No principal objections against carefully defined, generally applicable rules for if aimed at financial stability and prevention of market abuse. ► **US**: New SEC alternative uptick rule limits market practices, weakening competitive position of US vis-à-vis major EU markets, but not compared to HK, SG, JP. ► **EU**: Disclosure regime proposed by CESR is reasonable, save for public disclosure requirement which may raise issues including greater risk of herding. EU should ensure full harmonisation, no gold-plating by member states.
Coope-ration	► Increasingly fragmented landscape of short-selling rules around the globe: higher costs of compliance, more complicated assessment of market conditions, higher legal risks to meet local standards. ► IOSCO principles too broad to promote globally consistent rules. ► US and the EU should do utmost to arrive at equivalent regulatory framework.

Conclusion: Principles of optimal financial market oversight

- **Regulation**
  - Promote financial stability
  - Protect investors, consumers, and all other market participants from market abuses
  - Promote competition in domestic and international markets
  - Create and maintain efficient market rules resting on principles-based regulation
  - Avoidance of excessive regulation
  - Systematic, consistent and proportionate enforcement
- **Supervision**
  - Consistent oversight and enforcement of regulation
  - Strong inter-agency cooperation
- **International cooperation**
  - Close cooperation in drafting regulation and enforcement
  - Regulatory convergence
  - Avoidance of extraterritorial effects
  - Mutual recognition of U.S. and EU financial market regulation
  - Adherence to global standards

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