REGERINGSKANSLIET
Ministry of Finance

Financial Institutions and Markets
Fi2010/3634 *10-5913*

RIKSGÄLDEN
SWEDISH NATIONAL DEBT OFFICE

SVERIGES RIKSBANK

Financial Stability Department
2010-560-AFS

European Commission
Internal Markets and Services DG
Financial Institutions

markt-g3-consultations@ec.europa.eu

Response by Swedish authorities to the European Commission´s public consultation on short selling

The Swedish Authorities – representing the Ministry of Finance, Sveriges Riksbank, the Financial Supervisory Authority and the Swedish National Debt Office – welcome the opportunity to comment on the European Commission's public consultation on short selling. Before addressing the questions posed in the consultation, we would like to put forward some more general comments. They deal with the role of short selling in financial markets, something that is given little attention in the consultation document.

On the role of short selling

The Commission's document starts off as follows:

> Short selling of financial instruments (…) is an established and common practice in most financial markets.
>
> Short selling plays an important role in financial markets and is undertaken by a variety of market participants and for a variety of different reasons. It can be viewed as contributing to more efficient price discovery, increasing market liquidity, facilitating hedging and other risk management activities and helping to mitigate price bubbles and acting as an early indicator of problems relating to an issuer.

Against this it is noted that:

> It appears however that in some situations it can be used in an abusive fashion to drive down the price of financial instruments can contribute to disorderly markets and, especially in extreme market conditions, can amplify price falls and have an adverse effect on financial stability. It can also result in information asymmetries. In the case of uncovered short sales there may be an increased risk of settlement failures and price volatility.

The rest of the document is basically devoted to comments and questions relating to the second of these statements, with little reference to the first. Yet it is clear that if both assertions are correct, there is a trade off. On the one hand, there are common and established practices that are important for the smooth functioning of financial

markets. On the other hand, these same practices can "*in some situations*" cause certain problems in financial markets. An attempt to handle "some situations" by constraining such practices can thus be harmful to the functioning of markets in other situations.

We would argue that practices that can be subsumed under the definition of short selling, including its uncovered form, are important for the functioning of financial markets, not least fixed-income markets. Many instruments for perfectly legitimate risk management may fall into this category. Restricting such legitimate practices would prove costly. The experiences gained since the outburst of the financial crises provide empirical evidence on the impact of short selling that should be analyzed thoroughly before deciding on weather measures are called for. Broadly speaking, we consider the case against short selling as not proven. Our comments to the questions below aim to clarify why we come to this conclusion.

A. Scope

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

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

The Swedish Authorities have no evidence of risks related to short selling, even though Sweden was one of few Member States who abstained from introducing measures on short selling in the autumn of 2008 or later.

We consider that, in general, short selling is a natural ingredient in well-functioning financial markets. It enhances liquidity and allows investors with differing views on the value of an asset to influence the market price. It is also an important tool for risk management. The absence of short selling may thus pose greater risks than its presence.

We also find that there is little evidence that short selling has played in important role in recent periods of market turbulence. It may be that certain episodes of financial instability have been *accompanied* by increased short selling, e.g. in certain financial stocks or certain sovereign bonds. However, this can be interpreted as *symptoms* of underlying problems, rather than as causes of instability. If an entity is perceived to be in severe difficulties, many investors are no longer comfortable being long in the instruments that the entity has issued. Their desire to sell (or hedge) their positions will be enough to move the price significantly. This implies that restrictions on short selling are unlikely to be effective in preventing asset prices from adjusting.

Similar arguments can be made with regard to sovereign credit default swaps (CDSs). In most cases, this market appears to be too small and too thinly traded to be an important channel for wider market disturbances. We are not aware of any evidence pointing in the opposite direction.

Regarding sovereign bond markets, we are not aware of any concrete evidence of settlement failures that can be linked to short selling. If settlement problems in these

markets are a concern, there are other remedies available, especially for the government itself as the issuer of the instruments; we return to this topic below.

Moreover, it is not clear that the proposed definition of what constitutes a net short position in a meaningful way affects the ability of an investor to deliver a specific bond. As we note below, it appears to be based on an investor's duration-weighted aggregate position in bonds issued by a Member State. Settlement involves the ability to deliver a specific bond. If this interpretation is correct, the arguments based on concern for settlement problems are not relevant in the case of sovereign bonds.

Against this background, the Swedish Authorities support enhanced transparency along the lines suggested by the Committee of European Securities Regulators (CESR), i.e. only for specific instruments (option B) and preferably only for EU shares. Derivatives need to be included in the calculation of a net short position in their underlying instrument and should not be treated separately. Care need to be exercised not to extend a transparency regime beyond reporting to the competent authority without sufficient analysis, as the consequences of a public transparency regime does not seem to have been clarified.

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

Primarily in cases where an EU regulated entity takes part in a transaction.

B. Transparency

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

Only EU shares; cf. answers to questions 1–2.

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

No; cf. answers to questions 1–2.

(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 agree with the proposal for notification to regulators but remain concerned regarding public disclosure. A private disclosure regime would suffice in providing competent authorities with detailed information on significant short positions in the markets they supervise and would, over time, contribute to a better understanding of the effects of short selling. Public disclosure of short positions in EU stock markets should be limited to aggregate numbers, at least initially. Public disclosure of short positions that include also the identity of the person who has the net short position in question would serve no useful purpose, other than effectively prohibiting short positions of that size, as the closing of the position on reasonable terms would be made more difficult by informing possible counterparties in advance and also by inviting public comment. Prohibitions of short positions need to be decided upon explicitly, on the basis of appropriate impact assessments and public consultations.

(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; cf. answers to questions 1–2.

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

No, we are concerned with the proposed notification of short position in EU shares to the public and would support disclosure only of aggregate information, which in turn will require a different mechanism of disclosure (allowing for the aggregation of short positions).

(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?

If such a requirement is imposed, these exemptions will be highly desirable. Market makers take short positions as part of their business model, not with any intent to take positions on price changes. A transparency regime involving also market makers would seem disproportionate as they are continuously in the market, profiting from transaction volume rather than price changes and with only limited positions, if any, held over night. Separate information on possible short positions would therefore seem to be of limited value in this case.

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

As noted above, we consider measures beyond a reporting requirement on EU shares to be unjustified. It is for those who advocate new regulations to make the case that the proposed measures are proportionate and that the benefits exceeds the costs. No such analysis has been presented to date.

We fear that an introduction of public disclosure of short positions in EU shares would, among other things, introduce new risks for underwriters of share offers, possibly obstructing the prime function of stock markets, i.e. raising of capital.

C. Uncovered short sales

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

The risks pointed to in the Communication are increased risk of settlement failures and price volatility. We are unaware of any substantial settlement risks that would motivate regulatory action. As regards price volatility, we find it hard to believe that restrictions on uncovered short sales would address this issue in any meaningful way.

(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?

In Sweden there is no evidence that uncovered short selling of sovereign bonds is related to settlement failures. In fact, settlement failures are extremely rare. One reason is that the Swedish National Debt Office as the issuer of bonds have taken steps to prevent settlement failures. In particular, there is a system of securities lending (through repos) allowing primary dealers to borrow government debt instruments. An investor can therefore always turn to a primary dealer and, at a cost, borrow from the issuer any instrument she is committed to deliver. Issuers of mortgage bonds have similar systems in place.

This is a practical example showing that to the extent that settlement failures are a concern, there are more general and more effective measures available to sovereigns than bans on uncovered short selling. We would argue that sovereigns should approach this matter as issuers, taking responsibility for the smooth functioning of the markets for their own instruments.

We would also emphasise the difficulty of implementing a regulation of short selling of sovereign bonds in such a way that it actually affects the ability of an investor to avoid a settlement failure. An issuer of equities typically has no more than one type of shares outstanding. An issuer of bonds typically has dozens of different bonds outstanding, with differing characteristics regarding time to maturity, coupon etc. The Commission appears to take this into consideration by consistently using “bonds” in the plural in the definition of a short position (cf. p. 7, first two paragraphs). We have also noted that CESR, in extending their proposal for an harmonised transparency regime to bonds, have called for duration adjustment of positions in order to facilitate comparison between different instrument (issued by the same issuer). This implies that arguments based on concern for settlement problems are not applicable in the case of sovereign bonds.

If one were to take this step, standard methods used for managing fixed-income portfolios would be ruled out. For example, an investor may hedge the interest rate risk in a short position in a German ten-year bond with a long position in a French ten-year bond. This would presumably not be possible under the proposed ban of uncovered short selling. As another example, an investor holding a French government bond may hedge her interest- rate risk by selling a German bond using a futures contract. This is equivalent to an uncovered short sale of the German bond. As such it would probably not be allowed.

It is worth noting that a standard spot transaction can be seen as a (very short) forward contract with the time between the deal and delivery (often three business days) as the term of the “forward contract”. It is hard to see why uncovered transactions in spot and forward (or futures) markets should be treated differently. A consistent approach should be to either ban both types of transactions or to consider both to be acceptable.

We would consider a ban on uncovered short selling of fixed-income instruments as harmful to the smooth functioning of these markets. The likely result would be sharply reduced liquidity and, possibly, sharply increased funding costs. Since most sovereigns

are dependent on debt markets, not least in current circumstances, they stand to lose a lot from such a ban.

Recent experience has also demonstrated the importance of sovereign debt markets in times of financial stress. When other markets freeze over, banks and others rely on sovereign debt instruments for their liquidity management. This is also evidenced by the proposed Liquidity Coverage Ratio, which aims to ensure that banks have enough liquid assets to withstand a funding crisis. Here sovereign bonds are pointed out as appropriate for banks to have in their liquidity buffers. Measures that make these markets less liquid is therefore counterproductive also from the point of view of the ongoing reform of bank regulation and, more fundamentally, for financial stability.

(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?

No; cf. answer to question 11 and 12.

(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; cf. answer to question 11 and 12.

(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)?

As we are unaware of substantial settlement risks that would motivate regulatory action, provisions on buy-in procedures should be left to market participants to agree on.

(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. Absent any evidence to the contrary we consider the behaviour of CDS spreads as a symptom not a cause of market volatility.

(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 see no reason for introducing such a requirement.

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

As emphasised above (cf. question 12) we think that the implementation of a ban on uncovered short-selling in fixed-income markets would be very harmful, by hampering

liquidity and raising funding costs. A ban on uncovered short-selling of EU shares will incur costs by disallowing established market practices in some cases. We find it particularly important to establish whether there are any consequences for primary markets, i.e. in relation to the raising of equity capital.

D. Exemptions

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

Yes; cf. answer to question 9.

(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?

Yes, we agree with the CESR conclusion that it would not be appropriate to include shares within the scope of the transparency regime if their primary market is located outside of the EEA. Additional rules with regard to operators or markets outside of the EU should not be needed.

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

The effects of introducing unwarranted reporting requirements, i.e. for market makers or relating to shares whose primary market is located outside of the EU, would be higher administrative costs without compensating benefits.

E. Emergency powers of competent authorities

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

We need to look further into the issue of emergency powers and whether these can be tailor-made to provide for temporary restrictions of short sales of certain securities. We are not convinced of a need for emergency powers in relation to short selling or CDS transactions relating to the default of an EU Member State. If emergency powers are proposed, they should be temporary and restricted to emergency situations only, as outlined in the consultation paper.

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

We agree on a requirement to notify other Member States and ESMA before any action is taken under emergency powers. We question the value of a provision related to the purposes for which persons may enter into CDS transactions.

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

Yes, the limit should not exceed three months or, in exceptional circumstances, three additional months. The time period should be as short as possible to minimize the

disruption to the markets and should be clearly specified before the restrictions are put in place.

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

A requirement to notify other Member States and ESMA seem to be enough, given the co-ordinating role played by ESMA.

(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, interference with market prices should be generally avoided.

F. Powers of competent authorities

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

As already indicated (cf. question 22), we remain unconvinced on the need for emergency powers related to short selling. In any case, action under emergency powers should not be taken in other situations.

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

No comment at this stage.

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

ESMA should not be given additional powers related to short selling, in excess of [ESMA Regulation].