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Submission on Short Selling

Public Consultation by the European Commission

Directorate General Internal Market and Services

10 July 2010

Interest Representative Register ID number: 73788681242

About WEED

WEED – World Economy, Ecology & Development is a Berlin based specialist think tank and advocacy organization that has worked on global finance issues for about 20 years. It has outstanding expertise on the development impact of the international financial system. Its employees have been regularly testifying to the German parliament on financial market issues, and recently also to the IMF on financial transactions levies. WEED has been part of several EU funded projects on international financial markets, currently implementing two of them (one of them called "Towards a Global Finance System at the Service of Sustainable Development"). For more information please see www.weed-online.org.

General remarks

The general assessment of the consultation paper on short selling seems to be rather contradictory. First, it states that short selling *"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."* This positive assessment is surprising given the following critical remarks of the paper: "*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."*

While there may be some microeconomic evidence to support the above-quoted arguments on price discovery and liquidity, e.g. with the spreads of financial assets, the macroeconomic assessment is far less positive. Especially, short selling appears to contribute to crises rather than mitigating them, although – according to the theory behind it – this should be the time they are especially good for the market. In fact, short selling contributed to the 1929 crash, ruined countries as Malaysia or Thailand in the 1997 Asian crisis, and deteriorated the current global financial crisis.

When the dangers of short selling for financial companies became obvious to the authorities in the US, the UK or Germany, short selling was banned or at least publicly disclosed. German finance minister Schäuble, on 10 June 2010, said: *"The opinion which has been held for along-time that speculation normally would thwart exaggerations in the market, thus having a stabilising function, is not right anymore. After having experienced the crisis we have to assume that the modern financial markets with their interconnectedness and with their herd behaviour … aggravate the volatilities in the markets"* (our translation). A French government report from February 2010 also finds that *"the game of certain financial actors can strengthen the movements towards an upward or downward course thus aggravating the natural volatility of the oil price"*[1] (our translation).

It should be investigated more in detail what macroeconomic advantages really result from short selling, both covered and uncovered, and who has the true benefit of short selling and of today's financial market structure. While it is obvious that single actors can make huge profit with short selling of any kind, the profit for the whole economy remains partly unclear. A good example is the current crisis. Several hedge funds and banks have made billions of profits with short selling but this obviously has not prevented the crisis and did not keep the markets liquid.

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1 www.economie.gouv.fr/services/rap10/100211rapchevalier.pdf

In the latest scientific discussion, the economic ratio of short selling in general has even been questioned, suggesting that it is economically dysfunctional. Theoretically, short selling should not influence the price of the sold assets as this would signal abusive market power. The EU also points to this rightly. The crucial question is, however, what share of short selling is abusive. Hans-Werner Sinn, one of Germany's highest esteemed economists, in his 2009 book C*asino Capitalism* compares short selling to forward contracts, concluding that short selling is only of advantage for the speculator if he is able to borrow enough securities to influence the market: *"As the private advantage of short selling only exceeds the one of forward contracts if market power is exercised, short selling has no additional economic benefit"* (our translation). To the contrary, Sinn states, it would destabilize the market. Given this analysis, a complete ban of short selling might be reasonable.

We thank the European Commission for the opportunity to participate in the consultation and would like to respond as follows to the consultation paper:

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

We basically refer to the above remarks. The Final Report on "Regulation of Short Selling"[2] by the Technical Committee of the international Organization of Securities Commissions (IOSCO) from June 2009 (Appendix 1) identifies the following risks of short selling:

- First, the *"the process of decline may itself be disorderly"* and *"the outcome of any decline may be an 'overshoot' on the downside great enough to trigger undesirable secondary consequences.*"
- Second, its *"ability to add incremental weight to a downtrend, or to be used in conjunction with insider dealing by those with adverse information about an issuer, could make it a potentially useful tool for those who are intent on abusing a market."*
- Third, that *"where there is generally inadequate provision to ensure the timely settlement of short sales, there may be wider systemic risk."*

These risks or negative effects of short selling can be related to any kind of financial instrument and in any market. The question is not, if these effects occur but rather, how often they do.

An example of dysfunctional effects in the stock market occurred in October 2008 when a short squeeze of the Volkswagen shares resulted in an incredible short-term peak. Another example, and a especially problematic one, is Credit Default Swaps as a part of credit derivatives short selling. For decades if not centuries, financial markets were well off without CDS. The reason is that actually the security itself and its price should theoretically include all risks related to the paper. CDS create the illusion of improving the simple model by detaching risk and profit. The split of these two violates the basic economic laws of the capital markets that risk and profit should be inversely related. Regarding the risks with currency derivatives, we refer to the remarks below on question 12.

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

We are clearly in favour of Option A given the possible risks resulting from short selling.

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

2 www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf

The EU is not only responsible for the activities in its markets but also for the activities of all its legal entities, including all banks, funds, trusts and others. This is not only a political and moral imperative but also an economic one. The uncontrolled business of affiliates outside of the EU, often located in tax havens, has contributed to the crisis. We must not let this happen again. Therefore, all transactions of EU legal entities should be covered.

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

Transparency should apply to all financial instruments. As non-transparency of financial instruments has lead us into the current crisis, transparency is imperative now and should not be impeded by any business interest.

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

Yes.

(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?

As said, we prefer option A. But given that option B would be implemented, we recommend all positions to be notified.

(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?

We agree with the proposed notification proposal and support the public disclosure of significant short positions.

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

Not fully, please see comments above.

(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?

No, all activities should be covered. However, if there was an exemption, this should only apply to covered short selling.

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

We are aware that regulation could make trading more costly and will maybe lessen the liquidity of the markets. However, we think that the costs incurred in the crisis exceed the benefits of the before deregulated markets which seemed to be extremely liquid but suddenly turn out not to be at all just when liquidity was really needed. The economic advantage of modern financial markets is much less obvious than often stated by the financial economy itself. As former FED chairman Paul Volcker has notably remarked, he was not aware of *“one shred of evidence"*[3] that financial innovations fostered growth in any way. In fact, real net investments as share of GDP have declined in western economies for decades while profits have more and more been directed to a detached finance sector.

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

We basically refer to our general remarks. Uncovered short selling is pure gambling. This is why it had been regulated strictly in the US since the crisis in the 1930ies by the “Uptick Rule”. Today’s financial crisis began only some month after the 2007 abolishment of the “uptick rule”. As Muriel Siebert, former state banking superintendent of New York, wrote in the New York Times on August 2007: *“The S.E.C. took away the short-sale rule and when the markets were falling, institutional investors just pounded stocks because they didn’t need an uptick."*[4] Later details of the crisis, too, as for example the failure of Lehman Brothers or AIG, indicate that short selling was – amongst other reasons – responsible for the crisis.
Financial instruments including short selling strategies like CDS have reached a complexity and opacity that is not manageable any more. In no other business than in the financial markets it was imaginable to have this casino-like idea of doing business. As John Maynard Keynes said, *“speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.”* Now, after global casino has turned out to be disastrous in the so called developed countries – as is had been the case before for developing and emerging countries – the burden of proof is not with the opponents of speculation but with the speculators.

(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?

Short selling has proven to be dangerous for whole countries in the currency markets. By betting on falling prices, investors force central banks to counteract by selling their reserves. If a country has not enough reserves, the currency has to be devaluated and the investors gain huge profits. This has been the case for example in the Mexican crisis 1994/95 or in the Asian crisis 1997/98. This is why today, developing and emerging countries, especially in Asia, hold huge currency reserves to be protected against short selling speculation. However, this is binding financial resources which would be urgently necessary for the economic development of these countries.
Another form of harmful currency (and credit) speculation is carry trading, undertaken globally in order to benefit from interest rate level differences. In order to stop this practice, Brazil has even introduced capital controls this year.[5]

(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?

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3 http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6949387.ece
4 www.nytimes.com/2007/08/26/business/worldbusiness/26iht-morgenson.1.7256416.html
5 http://blogs.reuters.com/felix-salmon/2009/11/25/brazil-vs-the-global-carry-trade/

As said above, the borrowing principle behind covered short selling might be a problem in itself as it possibly regularly implies market abuse. At least, uncovered short selling should be banned completely as it is part of a detached finance sector.
There should be strict rules for the borrowing. No other than formal arrangements should be permitted. The informal way of dealing with arrangements has proven to be highly dangerous in the OTC derivatives market, and lead us into the crisis.

(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?

Yes, they should be permanently banned. Uncovered short selling is pure betting and while it creates profits for single market participants, the macroeconomic advantage is generally dubious. Furthermore, naked short selling can contribute to aggravate crises under certain circumstances.

(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.

Yes, there should be permanent limitations if naked CDS were not banned at all.

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

Yes, in order to have higher transparency.

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

Please see comment on question 10.

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

No. No exemptions should be allowed. However, if there was an exemption, this should only apply to covered short selling.

(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?

The EU is not only responsible for the activities in its markets but also for the activities of all its legal entities, including all banks, funds, trusts and others. This is not only a political and moral imperative but also an economic one. The uncontrolled business of affiliates outside of the EU, especially in tax havens, has contributed to the crisis. We must not let this happen again. Therefore, no exemptions or special rules should be allowed.

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

Market making activities might be restricted and more expensive. But, as the markets currently seem to be hyper-liquid, a slowing down of market activities is economically justifiable.

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

Measure-taking should not be temporarily limited to emergency situations.

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

No, they should be permanently. At least, the option for temporary measures should be available.

(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%)?

Yes.

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