Opinion of the European Economic and Social Committee on 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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Rapporteur-General: Mr MORGAN

On 7 October, the European Parliament and, on 13 October 2010, the Council decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union, on the

Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps


On 20 October 2010 the Committee Bureau instructed the Section for the Single Market, Production and Consumption to prepare the Committee’s work on the subject.

Given the urgent nature of the work, the European Economic and Social Committee appointed Mr Morgan as rapporteur-general at its 468th plenary session, held on 19-20 January 2011 (meeting of 20 January), and adopted the following opinion by 200 votes to four with seven abstentions.

1. Conclusions and recommendations

1.1 Short selling of equities in financial institutions was banned by the UK and other countries as a reaction to the post Lehman market meltdown. In response to the Greek sovereign debt crisis the German authorities banned short selling of the shares of certain German financial institutions, eurozone sovereign debt and ‘naked’ CDS positions in that debt. In this regulation, as part of its revision of financial regulation and supervision, the Commission proposes a single framework under the ESMA umbrella for the management of short selling and CDS throughout the EU. The EESC welcomes this initiative which will eliminate conflicting regimes and bring clarity to this area of the financial markets.

1.2 The EESC believes that, in general, outcomes will be optimum if markets are allowed to operate freely within an established regulatory framework. The EESC emphasises the importance of the ESMA umbrella. In the light of circumstances which ESMA considers to be adverse, ESMA may:

— prohibit persons from engaging in any trading, or limit the value of such trading;

— prohibit persons from entering into short sales or impose conditions on such sales;

— prohibit sovereign credit default swaps transactions;

— limit the value of sovereign CDSs; and

— require public disclosure of short selling.

1.3 In general, the EESC would expect Member State Competent Authorities to exercise these powers in the first instance. ESMA coordination of Member State responses meets an existing need and will be highly beneficial. The EESC would expect direct ESMA intervention to be exceptional as foreseen in Article 24 of the regulation.

1.4 The EESC welcomes the proposal for a regulatory framework that will give competent authorities powers to require additional transparency for the instruments covered by the regulation. On a day to day basis, this will benefit regulators, investors and markets. Should any future intervention be considered, we can expect the regulators to be better informed than heretofore.

1.5 The EESC welcomes the proposal to formalise within a harmonised framework powers to place temporary restrictions on short selling when market stability is threatened. The EESC notes that objective measures of market instability remain to be defined. The current threshold for ‘significant price falls’ of 10% could be too low for some instruments.
1.6 Subject to the provisions in paragraph 1.5 above, the Committee does not feel that an outright ban on naked CDS in all circumstances is justified.

1.7 The EESC considers that the proposed settlement regime for naked short selling could be more effective if there should be at least intra-day flexibility to cover short positions. The rather more flexible US model should provide the necessary assurance without putting market operators at a disadvantage.

1.8 The EESC supports the proposal for a two tier disclosure regime for equities, disclosing first privately and then publicly. This will give appropriate notice to both the regulators and the market.

1.9 The EESC is doubtful about the provision for the marking of short orders. The complexity is considerable, the utility is questionable and it will be a burden on all EU trading venues. The other transparency measures appear to be more than adequate to give control of the markets to ESMA and the Competent Authorities.

1.10 CDS related to sovereign debt have been the focus of eurozone angst as the sovereign debt crisis has erupted. The economic and social dimensions of this crisis are of enormous concern to the EESC. The Committee believes that naked CDS trading amplified the crisis and so it welcomes the regulation proposal. The Committee endorses the Commission’s view, contained in Recitals 16 and 17 of the Explanatory Memorandum of the regulation, that ‘uncovered short selling of shares and sovereign debt is sometimes viewed as increasing the potential risk of settlement failure and volatility. Measures relating to sovereign debt and sovereign credit default swaps including increase transparency and restrictions on uncovered short selling should impose requirements which are proportionate and at the same time avoid an adverse impact on the liquidity of sovereign bond markets and sovereign bond repurchase (repo) markets’.

1.11 In summary, the Committee welcomes the regulatory role of ESMA as it is defined in the regulation. Excessive intervention could destabilise markets. The EESC welcomes the provisions for market transparency which it expects to be very beneficial. It welcomes most of the technical provisions with the exception of the concerns detailed above.

1.12 Taking account of the damage that out of control sovereign debt can cause to all citizens, the EESC expects the EU to give a global lead in the future management of sovereign debt.

2. Introduction

**Short Selling**

2.1 The term ‘short selling’ means selling shares that are borrowed, rather than owned. Institutions which lend shares charge a fee which provides extra income for their funds. The borrower sells the shares in the expectation that the price will fall so that, in due course the shares can be repurchased at a lower price so that they can be returned to the lender, leaving the borrower in profit. Short selling is evidently risky. The loan of the shares may be arranged before the sale (covered short selling) or after the sale (‘naked’ or ‘uncovered short selling’).

2.2 Short selling can be used for a variety of reasons. Because both individual shares and the stock market as a whole can fall as well as rise, a portfolio of shares designed to rise with the market (a long position) is vulnerable to loss of value when the market falls. This type of ‘long’ portfolio can be protected by a ‘short’ component. While many institutions are ‘long’ only, some may be ‘short’ only. It is a moot point as to whether a long only portfolio, betting on upward market movement, or a short portfolio, betting on price falls, is the most speculative.

2.3 Short selling is used by a wide variety of market participants, ranging from traditional fund managers, such as pension funds and insurance companies, investment banks, hedge funds and market makers. Individual investors may also use short selling as part of their investment strategy. Short selling is regarded as a legitimate investment technique in normal market circumstances.

2.4 As rightly stated by the Commission, short selling is an established and common practice in most financial markets and should not be confused with market abuse, which is separately regulated in the EU. Rather, short selling has positive effects on the financial markets, including notably improved price discovery and reduced risk of bubbles as well as greater market liquidity.

2.5 In September 2008, days after the Lehman default, the UK prohibited the short selling of shares in publicly-quoted financial companies. Many other countries, including the USA, imposed similar restrictions, but for varying time periods. The new EU regulation will avoid any repetition of these disorderly measures.
2.6 The toxicity of the sub-prime derivatives, the viral nature of the cancer and the enormity of the melt down necessarily provoked action by regulators, even though their impact on the course of the crisis is debatable. It is difficult to envisage a similar future event, but in any case the framework now exists for an orderly response by supervisors and regulators.

Credit Default Swaps

2.7 Credit Default Swaps (CDS) are derivative contracts tied to an underlying debt security such as corporate bonds and government (sovereign) bonds. They are used to insure against the default on that debt. The protection buyer makes quarterly premium payments - the ‘spread’ to the protection seller. The spread of a CDS is how much must be paid to maintain them, and the spread widens in step with the perceived risk of default on the underlying debt.

2.8 If the borrower defaults, the protection seller pays the buyer the par value of the bond in exchange for physical delivery of the bond. A default may include such events as failure to pay, restructuring and bankruptcy. Most CDS are in the $10–$20 million range with maturities between one and 10 years. A CDS is similar to credit insurance, although CDS are not subject to insurance regulations.

2.9 Investors can also buy and sell protection without owning any of the debt being insured. These ‘naked credit default swaps’ allow traders to speculate on debt issues and the creditworthiness of the issuer. For example, if a supplier to General Motors had been concerned that GM was potentially insolvent, a naked CDS on GM bonds could have provided protection. Similarly, investors in sovereign debt can use CDS to create synthetic long and short positions in the selected bonds which in some cases may be a better way to create a portfolio.

2.10 It is important to avoid confusion between naked CDS and the naked short selling of stocks and shares. In the latter case, borrowed stock is sold. This can be a problematical concept. In the case of naked CDS, no sale is involved. A willing buyer has bought an option on a bond from a willing seller. As in any market, a price is struck. The performance of the underlying bond will decide which party profits. Naked CDS form the largest part of the CDS universe.

2.11 In May 2010, Germany announced a ban on naked CDS referencing Euro zone countries, as well as naked short sales of Euro zone sovereign debt and equities of certain German financial institutions. The regulator cited the ‘extraordinary volatility of debt securities’ to justify the move. This action took other Member States by surprise and upset the markets. As with short selling of equities, the new EU regulatory powers and provisions will prevent a repetition of such unexpected unilateral action in future.

2.12 While the focus on CDS is justified, there is still a danger that it deals with the symptom of the problem not the cause. The cause is the unresolved political and economic dilemma in which a currency union is faced with a debt crisis. The dilemma has caused economic uncertainty. Lenders need to cover their risks. Opportunists seek to profit from the uncertainty. It is difficult to separate one from the other. Bankers may be profiting, but eurozone governments are giving them every opportunity to do so.

2.13 In the light of the above, and taking account of the damage that out of control sovereign debt can cause to all citizens, the EESC expects the EU to give a global lead in the future management of sovereign debt.

3. Gist of the Regulation

3.1 The proposal covers shares and derivatives relating to shares, sovereign bonds and derivatives relating to sovereign bonds and credit default swaps relating to sovereign issuers.

3.2 The proposal applies transparency requirements to natural or legal persons (henceforward persons) with significant net short positions relating to EU shares or EU sovereign debt or with significant CDS positions relating to EU sovereign debt.

3.3 For shares, a two tier transparency model is proposed: at a lower threshold, notification of a position must be made privately to the regulator; at a higher threshold, positions must be disclosed to the market.

3.4 The lower tier threshold proposed is 0.2 % of the issued share capital. The upper tier threshold is 0.5 %.

3.5 For EU sovereign debt, private disclosure is required of significant

— net short positions in sovereign debt,

— uncovered positions in CDS relating to sovereign debt.
3.6 Notification is also required when short positions are taken via either OTC (over the counter) transactions or by derivatives such as options, futures, etc.

3.7 There is also a requirement that short sales at any venue should be flagged so that the venue can publish daily information about volumes of short sales at that venue.

3.8 Persons entering into short sales of shares or sovereign debt must, at the time of sale, have either borrowed the instruments, entered into an agreement to borrow them or made other arrangements to ensure that the security can be borrowed so that settlement can be made when it is due.

3.9 Where a person who has sold short is not able to deliver shares for settlement on time, the trading venue will acquire shares to complete the sale and recover costs from the short seller. The short seller will pay a daily charge until the sale is settled.

3.10 Settlement periods vary between jurisdictions. Settlement generally is an issue which remains to be addressed.

3.11 In exceptional circumstances, it may be necessary to prohibit or restrict short selling activities that would otherwise be legitimate or pose little risk. In such cases competent authorities should have temporary powers to require further transparency or impose restrictions on the market.

3.12 Because of the EU wide ramifications of such measures ESMA (European Securities Market Authority) will be given two key roles: coordination of intervention between Member States and validation of the restrictions imposed by each Member State, especially with regard to the duration of any restriction.

3.13 Where a situation has cross border ramifications and ESMA deems that the measures taken by the competent authority are inadequate, ESMA may itself intervene, overriding the Member State competent authority.

3.14 The Commission is given the power to further define criteria and factors that must be taken into account by both ESMA and competent authorities in determining when adverse events or developments create a serious threat to financial stability or market confidence.

3.15 Competent authorities are given the power to impose a very short prohibition on short selling of instruments or otherwise limit transactions to prevent a disorderly decline in price. This 'circuit breaker' would be triggered by objective criteria.

3.16 The proposal gives competent authorities all the powers necessary for the enforcement of the rules. The proposal requires Member States to provide for rules on administrative measures, sanctions and pecuniary measures necessary for the implementation and enforcement of the proposal.


The President
of the European Economic and Social Committee
Staffan NILSSON