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European Commission Public Consultation on Short Selling

Reply from NASDAQ OMX

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Initially, we wish to highlight some general points in relation to the proposal for measures related to short selling.

As the Commission rightly points out, short selling plays an important role in financial markets, in a positive sense. We are not convinced of the conclusion that short selling is to a significant extent used in an abusive fashion to drive down prices and contributes to disorderly markets. Nor that short selling can amplify price falls and have adverse effect on financial stability. On the contrary, during the most turbulent times when short selling increased on our markets, there were also other special conditions clearly impacting prices, and we did not necessarily observe significantly larger price movements in those stocks in which short selling increased compared to other stocks. We believe there is simply not enough established evidence that short selling needs such regulatory measures as proposed in the consultation paper. The measures proposed in the consultation paper risk reducing the positive role short selling plays in financial markets, they risk not having any positive effects and they are disproportionate. It would instead be appropriate for the Commission to back the proposals in the consultation paper with academic findings.

If one believes that short selling may have such negative effects as described in the consultation paper and referred to above, one has to recognize that the same effects of

short positions may be achieved by the use of derivatives positions. By introducing a regulatory regime on short selling, the aims will not be reached. Other market practices will continue unregulated. This also puts the proposals in question.

Also, to have the intended effect, the proposed measures need to apply to positions taken outside regulated trading venues. The possibly speculative actions that have recently triggered local restrictions on short selling, have primarily been conducted using instruments that were not admitted to trading on regulated markets but that were traded OTC. Not only will the intended effects not be realized if the OTC market is outside the scope of the short selling regime, but leaving the OTC space unregulated would also incentivize a move of trading activities to unregulated venues. The measures would run counter to the intentions expressed by G20,EU institutions as well as globally to increase transparency and reduce the opacity of markets. Furthermore, if measures are introduced that place a burden on those that make use of regulated venues, this affects the level playing field vis-à-vis OTC markets. It seems most relevant to focus measures on OTC markets rather than on practices taking place on regulated venues, where the level of transparency is already high.

I order for measures on short selling to have effect, one also needs to underline that markets are global, and measures introduced only in EU will only have limited effects, and may possibly move business outside the EU.

In addition, we wish to underline the importance of ensuring that the measures are linked to the intended effects. For instance, regarding disclosure, the measures need to be adapted to the intentions – is disclosure meant for information to the market and/or for regulators to be able to investigate abusive behavior, to take emergency measures or to do analyses at macro level?

It is our opinion that the measures proposed in the consultation are not justified and indeed not proportionate. They are not detailed enough for respondents to sufficiently analyse and understand the proposals, or to provide as useful comments as would have been preferred. We urge the Commission to reconsider its proposals. Before the proposals could be moved forward, it would be needed to provide justification, to elaborate on the details and to provide sufficient time for consultation.

Should nevertheless the Commission decide to move forward, please find below a summary of the responses from NASDAQ OMX, and the answers to the questions that we were able to provide within the limited consultation period.

We welcome the harmonization of powers and tools available to authorities. This will support a smoother operation of any regime adopted.

NASDAQ OMX also reiterates that public disclosure of short selling positions should be made by the regulator on aggregated level, not by individual participants.

Naked short selling should not be banned or subject to conditions. Any measures should instead be focused on settlement failures and encouraging central clearing.

Emergency powers need to be well-defined in order for the application of such rules to be as foreseeable and as harmonized as possible and they also need to be as limited in time as possible. This is necessary to support the well-functioning of the financial

markets. Emergency situations should be detailed and an open consultation should be carried out.

A. SCOPE

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

We do not specifically see the risks of short selling, nor as such, neither related to specific instruments. Possible risks seem to be concentrated to OTC markets rather than to activities taking place on regulated venues.

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

If measures are to be introduced at all, we prefer an option closer to B than to A.

It should be carefully considered which instruments need to be covered by the measures proposed by the Commission. It needs to be recognized that a scope covering all instruments admitted to trading on regulated markets, and only those, will have restrictive impacts on the trading taking place on transparent venues, while leaving OTC markets unaffected. This seems ill balanced, as much of the debate on possible speculative activities seem to concern CDSs traded OTC, rather than trading activities on regulated venues.

However, the details of the scope of option B would need to be outlined in more detail before a detailed answer can be provided.

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

Any measure imposed in relation to an instrument admitted to trading on a regulated market within the EU needs to apply to this instrument irrespective of where a transaction is carried out. Otherwise there is a risk for regulatory arbitrage and loopholes, and the EU measures will not have the intended effect. Also, measures limited to regulated venues may incentivize OTC trading, thus favoring the more opaque trading venues over the transparent venues.

B. TRANSPARENCY

General comment

If a transparency regime is introduced and for it to be as efficient as possible, NASDAQ OMX strongly agrees that calculations of net short positions should also include such positions created by trading both on regulated venues and OTC and also positions created by the use of derivatives.

It is also necessary to keep in mind the purposes of a transparency regime – is it for public disclosure to the market, or for private use by the regulators? It seems appropriate that regulators may need more information than the market.

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

The consultation paper lacks an explanation for why all or some types of instruments would need to be covered by a transparency regime. A regime should not be adopted unless there is a need for information disclosure.

For shares admitted to trading on a regulated market, we have already in our response to CESR's consultation on a pan-European transparency regime, welcomed a harmonized approach to transparency. The benefits would be that reporting regimes would be harmonized across Europe and cross-border business would be facilitated as market participants would not need to comply with a multitude of different reporting rules. ESMA should be given an important role in supporting a harmonized implementation and application of the regime.

For other instruments, especially as regards CDSs, where the OTC market plays a large role, it seems less appropriate to determine a scope related to what instruments are admitted to trading on regulated markets. This would place a burden on the trading taking place on regulated markets, but not achieve much. We also question whether specifically targeting sovereign bonds would provide regulators with more than a fragment of the overall picture.

Q 5. Under option A, is it proportionate to apply transparency requirements to all types of instruments that can be subject to short selling?

Even if a regime applied to all instruments admitted to trading on a regulated market, it would anyway not capture all relevant information, as it does not cover OTC markets, especially for CDSs.

Q 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?

For notification to the regulator, the 0,2% threshold seems high. If regulators are to make effective use of the information, the threshold may need to be lower.

However, the proposal for public disclosure needs to be significantly adjusted. As already underlined in our response to CESR's consultation in relation to a pan-European short selling disclosure regime, disclosure to the markets should be done on aggregated level by the regulator. The purpose of public disclosure as described by CESR is to provide informational benefits to the market, improve insight into market dynamics and make available important information to assist price discovery. These purposes would be achieved by aggregated disclosure by the supervisor, which would give a comprehensive picture of the status of short selling activities per instrument. Such a system would reduce the risk of the information being very fragmented and more complicated to analyse for the market. Also, the short seller may have a legitimate interest in not disclosing his/her positions, especially at the low levels as suggested by CESR (0,5%). Indeed, there are important risks in publishing such information to the

market. Information on individual positions may open up for wider abusive behavior, such as front running and squeezes. Such behavior has serious impact on price formation. The threshold at which aggregated information should be disclosed could be significantly higher than that for the market participants' reports to the supervisor, possibly around 5%.

It may be added that NASDAQ OMX regularly publishes aggregated data on securities lending, for which we see a high demand.

Q 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 the notification to regulators, should there be public disclosure of significant short positions?

A disclosure regime only aimed at sovereign debt would not be efficient. It seems that either all types of debt instruments should be included, also instruments traded OTC, otherwise regulators will not have a full picture, or instead the regulators could be empowered to ask for information when needed.

For public disclosure, we also see that there could be a value for the market if the information gathered by regulators were published in aggregated form.

Q 8. Do you agree with the methods of notification and disclosure suggested?

The TRS system and the OAMs could provide a good structure to build on.

Q 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. If there is a regime in place it should apply equally to all participants. Otherwise there is a risk that activities are driven outside the transparent space.If the market maker position is never reported, anyone can trade any instrument (future, swap, repo, CFD, etc.) against the market maker instead of in the market, thus deteriorating transparency. We would prefer that market makers are required to report their positions to the supervisor and that this information is included in the statistics to be made available to the market on an aggregated level. The market maker positions would then be part of the general statistics, but not disclosed in their names.

If an exemption is to be granted, it would be important to find a very narrow definition of market maker. Considering the wide variety of practices that may today be considered as market making activities, we question whether it is feasible to find a narrow definition. This again is an argument against allowing an exemption.

Q 10. What is the likely cost and impact on different options on the functioning of financial markets?

Costs are very difficult to estimate. A regime that misses the goal will add cost and administration without achieving a benefit. Inefficiencies are costly.

C. UNCOVERED SHORT SALES

General comment

It is important to reiterate that short selling is a useful feature in financial markets. Disproportionate restrictions will curb liquidity, which will cause the costs for legitimate activities to increase.

It is also important to point out that even if a position may be naked at the point of selling, it is not a given that there will be a settlement failure. By introducing restrictions applicable at the point of selling, also perfectly legitimate transactions will be unduly restricted. This seems ill justified and disproportionate.

As most instruments subject to naked short selling is not traded on regulated exchanges (i.e. CDSs), the proposed rules seem somewhat misdirected.

It is also worth pointing out that for transactions that go through a central clearing house, there are already default regimes in place via the CCP. Instead of regulating naked short selling, it would be more appropriate to concentrate on encouraging CCP clearing.

Q 11. What are the risks of uncovered short selling and what is the evidence of those risks?

We do not see evidence of risks. In or markets we have not seen significant problems with settlement failures.

Q 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?

No.

Q 13. Do you agree with the proposed rule setting out conditions for uncovered short selling? Do you consider that more stringent conditions should be put in place? If so, please indicate which ones? Do you agree that the arrangements other than formal agreements to borrow should be permitted if they ensure that shares are available for borrowing settlement? If so, why?

No. From our experience, delivery may very well take place even though the seller may not own/borrow the instrument at the point of sale. Setting conditions risks having an unintended damaging effect on legitimate and useful short selling. If the purpose is to reduce price volatility, conditions for short selling will not have any effect. There should be no conditions. It is better to find a well working regime for actual settlement failures and to encourage CCP clearing as mentioned above.

Q 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. We are not convinced that restrictions on short selling will have any positive effects. On the contrary, there may be more negative effects.

Q 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)?

Buy in procedures are best placed at settlement level. As already mentioned, CCP clearing regimes take care of delivery failures for transactions put to central clearing. For other transactions, a buy in regime should be placed at settlement level. For it to be efficient, it is also crucial that it is sufficiently supervised and enforced, and that sanctions are appropriately discouraging.

Q 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. See above in this section C.

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

No.

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

Difficult to estimate. If measures are imposed that have adverse effects on financial markets, on liquidity, on inefficiency, which cost.

D. EXEMPTIONS

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

The fact that market making activities could be exempt, in our view is recognition of the usefulness of short selling, even uncovered short selling. This again raises question marks as to why restrictions on uncovered short selling would be justified broadly.

In case uncovered short selling will anyway be subject to any type of requirements or restrictions, the same rules should apply to all, market making activities included. As already stated above under Q 9, we believe market makers should not be exempt from the transparency requirements, and they should comply with the same rules on uncovered short selling as the rest of the market. Otherwise, it could create incentives for OTC trading vis-à-vis trading on more transparent trading venues.

Should market makers anyway be exempt from transparency requirements, it is necessary to apply a very narrow definition of market maker and ensure that the exemption only applies to proprietary trading carried out in relation to market making.

Q 20. Do we need any exemptions where the principal market for a share is outside the European Union? Are there any other special rules needed with regard to operators or markets outside the European Union?

It is important that the same short selling regime applies to a share, irrespective of where the share is traded. Either a short selling regime applies to all markets where the share is traded, or no regime applies. Otherwise, there will be room for arbitrage and loopholes. EU should ensure that sufficient cooperation arrangements are in place between the EU and those countries where shares admitted to trading on a regulated market in EU is also traded on markets outside the EU.

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

As regards market makers, see the answer to Q 19 above.

As regards non-EU countries, see the answer to Q 20 above.

E. EMERGENCY POWERS OF COMPETENT AUTHORITIES

Q 22. Should the conditions for use of emergency powers be further defined?

Yes. The market suffers from uncertainty. The conditions for invoking emergency powers should be as detailed as possible and a new consultation should be carried out for this. The consultation paper does not provide sufficient details. See also the answer to Q 23 below.

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

Before restrictions are imposed, it is important that Competent Authorities carefully weigh the pros and cons of restrictions. For instance, restricting short sale will have the effect of destroying totally legitimate strategies, in which short selling is but one leg.

Since we are not convinced about the benefits of the proposed emergency powers, we also have difficulties finding a role for ESMA. It is important that the imposition of emergency measures is limited to the Member State that deems that there is an emergency situation. Other Member States should not be forced to apply the emergency measures imposed in another Member State. For this reason it seems important to underline that the powers to impose of emergency measures should remain nationally, and not be transferred to ESMA. It must be the task of those Competent Authorities considering the imposition of emergency measures to explain the reasons for it and for the other Competent Authorities to maintain their sovereignty in deciding what is appropriate for their home markets. ESMA should however maintain a coordinating role, facilitating the exchange of views between Competent Authorities.

As the powers of one Competent Authority should not extend beyond its jurisdiction, more details are needed on how such emergency measures could be effective, as the same financial instruments can be traded in several Member States. It seems that emergency restrictions will not provide solutions.

In addition, in order to possibly support swift handling by ESMA and Competent Authorities and to provide the market with as much certainty as possible, the conditions for use of emergency powers should be further detailed. The proposed 24 hour time period allowed for ESMA and other Competent Authorities to analyse and provide views on the action proposed is indeed very short. It can be questioned whether this procedure will in practice allow for appropriate coordination to be effectuated. It is true that emergency situations by nature require quick responses. Nevertheless, coordination and harmonized actions are essential in order to avoid other negative effects on the functioning of the markets, so a longer time period seems necessary.

Q 24. Should the restrictions be limited in time as suggested above?

Yes, in order to intrude as little as possible on the normal functioning of the markets restrictions need to be strictly limited to short time periods.

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

See answer to Q 23 above.

Q 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%)?

Something similar to circuit breakers, which are in use on US markets, could be considered also for European markets.

F. POWERS OF COMPETENT AUTHORITIES

General comments

It should be ensured that all competent authorities have the same powers to seek further information regarding any supervisory purposes. It seems that the suggestion in the consultation paper to give powers to competent authorities on the purposes of anyone entering into a CDS transaction, is related to the general aim to ensure financial stability. If so, the powers for competent authorities should be looked at more broadly than only in relation to the purpose of entering into a CDS transaction.

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

We are still lacking support for the view that restrictions on short selling is an appropriate measure. For this reason, we object to introducing powers to impose such restrictive measures.

Should nevertheless such powers be introduced, they should be limited to emergency cases only. However, before this is introduced, a consultation on what may constitute such emergency cases should be carried out.

Q 28. Are there any special provisions that are necessary to facilitate enforcement of future legislation in this area?

Competent authorities need to have the powers to enforce any rules applying to financial market participants, be these rules stated in EU law, in national regulations or imposed in the form of emergency measures. This is crucial in order to ensure that the rules are complied with uniformly.

Q 29. What co-operation powers should be foreseen by ESMA on an ongoing basis?

In relation to short selling, coordination powers should be strong in order to ensure harmonized regulatory solutions across the EU. The current coordination by CESR in relation to short selling has not achieved a harmonized solution.

G. GLOSSARY OF DEFINITIONS

Q 30. Do the definitions serve their intended purpose?

"Principal market" probably needs to be defined with more detail, or at least the process of finding the principal market should be described or referred to.

"Short sale"

- "the time of the sale" may need to be specified, possibly "the time of the entering into the agreement" is better.
- In relation to derivatives a separate definition may be needed. It does not seem to be relevant to demand that the underlying security be held from the time of entering into a derivatives contract until delivery.