



CONSOB POSITION PAPER ON SHORT SELLING*

CONSULTATION RESULTS

26 November 2009

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CONSULTATION RESULTS

REGULATORY OPTIONS ON SHORT SELLING

Since September 2008, following the insolvency of Lehman Brothers, the financial markets have experienced exceptional tension and volatility. Concerned about the probability that short selling could contribute towards sharpening tension on the markets, the Supervisory Authorities of the leading countries adopted a series of measures aimed at limiting, to a differing extent, the practice of short selling.

In this context, Consob adopted a series of **temporary** restrictive measures, the extent of which depended on market conditions. On each occasion, in fact, Consob tightened or relaxed the short selling restrictions to take into account the gradual changes in market conditions. Waiting for a harmonised decision at European level, the most recent measure (see Resolution no. 16971 of 28 July 2009) eliminated the temporary restrictions on short selling except with regard to shares of companies that agreed a share capital increase by 30 November 2009. These companies were given the option of requesting exemption from application of the measures (see Resolution no. 17034 of 14 October 2009). The short selling ban on shares of companies subject to share capital increases has not been renewed (see Resolution no. 17078 of 26 November 2009).

On 27 May 2009, Consob published a Position Paper on short selling, identifying the various regulatory options potentially suitable for **permanent** regulation of short selling. The public consultation closed on 15 July. Twelve responses containing comments on the regulatory options identified in the Position Paper were received and published on the Consob website. These responses were submitted by ABI, Assogestioni, Assonime, Assosim, Bloomberg, Borsa Italiana, ICFAS (the Italian CFA Society), IMA (Investment Management Association), ISLA (International Securities Lending Association), two natural persons and one person preferring to remain anonymous.

This document, in two parts, informs the market about the comments received in response to the Position Paper (Part I) and about subsequent evaluations performed by Consob (Part II). Specifically, Part II includes an analysis of market failure associated with short selling and, taking this analysis into account together with the contributions from persons consulted, identifies which of the regulatory options proposed in the Position Paper ought to be studied further, given that, at present, their costs do not seem to be higher than their potential benefits.

The purpose of this document is not to identify a final regulatory option for short selling, but rather to deepen the preliminary analysis performed in the Position Paper, in the light of comments received from consultation participants. In effect, the choice regarding the final regulatory option to be adopted has to take into account decisions made over the next few months at European level. As already clarified in the Position Paper and broadly recommended by the persons consulted, *“A careful assessment of the choices which the other countries intend to make, as well as the recommendations deriving from supranational organizations, is essential, for the purpose of identifying a regulatory solution which, in observance of the afore-mentioned recommendations, does not open the way up to evasive phenomena due to possible regulatory arbitrage, which does not create distortions, and which does not affect the competitive set-up between regulated markets subject to different regulatory systems, between various trading systems and between spot and forward markets. Effects of this type are much more probable the more the regulations are prescriptive and, in particular, the more the same effect the conduct of the individuals or the general operating and disclosure activities of the*

trading activities". *"On the other hand, it is evident how the costs and benefits associated with the various regulatory options depend on the presence or otherwise of a harmonized regime"* (Position Paper, p.13).

In this respect, it should be mentioned that on 8 July 2009 the CESR published a consultation paper on a reporting system (to supervisory authority) and transparency (to the market) harmonised at European level. This consultation ended on 30 September 2009. The CESR expects that a final proposal will be ready by the end of this year. The final proposal will be submitted to the European Commission for its consideration. Submission will be necessary as, in reference to the legal basis of the proposed model, the CESR proposal will recommend the adoption of ad hoc European legislation - either a directive or a regulation - or alternatively the adoption of suitable amendments to the Transparency Directive.

The potential European harmonisation of regulations on short selling means that, at present, it would be appropriate to avoid national regulatory initiatives which might not have the stability necessary to avoid excessive costs and market uncertainties. On the other hand, given that the institutional steps to be followed to achieve European harmonisation is a complex process, it is considered worthwhile to begin further study and analysis of the regulatory options, based on this document, and to share findings with the market, also to provide a further contribution to European debate on this matter alongside the institutional participation to international organizations, such as the CESR.

PART I: SUMMARY OF THE MAIN CONTRIBUTIONS RECEIVED DURING CONSULTATION

The persons consulted expressed widespread appreciation of the quality of the Position Paper submitted for consultation, particularly with regard to the preliminary impact analysis of regulation conducted to assess the various options examined, the results of which meet with their overall agreement.

In general, the persons consulted consider that short selling has beneficial effects on the market in terms of liquidity and price discovery efficiency, and believe it to be an integral part of operators' investment policies and risk management strategies. Given these benefits, the persons consulted do not perceive the presence of significant costs in connection with short selling. In this respect, the ABI emphasises that *“there is no real evidence of causal links between short selling and phenomena such as excessive volatility or market manipulation. In addition, from theoretical evidence available to date it would seem that the restrictive measures adopted on short selling have not led to substantial benefits to the market, but rather only costs in terms of liquidity and price discovery efficiency”* (ABI, Assosim).

In the light of these comments, almost all persons consulted would be against prohibitive regulatory and transparency options, while they express differing opinions on the introduction of reporting regimes and measures to improve settlement procedures.

The introduction of a **permanent ban** on short selling – either an across-the-board ban or a ban on naked sales only – is seen as unfavourable by all consultation participants except for Assogestioni, which would be in favour of a permanent ban on naked short sales only. Assosim, against any form of short selling regulations, suggests that, if a ban on naked short sales were adopted, coverage would need to be allowed up to the end of the trading day and not before issue of the sell order.

With regard to permanent ban options, the following comments were also received:

- restrictive measures could prove totally ineffective considering that *“institutional customers, especially non-Italian, use brokers that do not have custody of the securities. This means it would be impossible for the intermediary to perform any means of control over the type of sale (covered or naked) except to rely on customer declarations, these too without confirmation. Any ban imposed would therefore prove ineffective”* (ABI);
- market manipulation transactions executed through short sales not backed by availability of the securities could be suitably discouraged through adequate enforcement of market abuse regulations and appropriate rules on settlement procedures (ISLA, ICFAS).

With regard to the option of Consob retaining the power to intervene with **prohibition measures in exceptional circumstances**, ABI, Assonime and Bloomberg are in favour. In abnormal market conditions, in fact, the benefits associated with short selling could disappear, and restrictive measures could be adopted to reduce volatility and to bring trading back to normal.

Borsa Italiana, ISLA and Assosim are sceptical, however, about the usefulness of recent restrictive measures adopted by the supervisory authorities.

Regarding the **option of a ban on short sales not backed by securities lending in the event of share capital increases**, the persons consulted were generally against the idea. However, if such a measure is adopted, Assosim requests clarification regarding the entities subjected to the measure and the period the ban would remain in force. In fact, Assosim states that *“it is often very difficult to identify companies subject to the restrictive measures. For example, for share capital increases delegated to the Board of Directors pursuant to art. 2443 of the Italian Civil Code, it is difficult to identify when the increase terms can be considered “fully defined”. Likewise, identification of the closure date of the share capital increase would be uncertain (...)”*.

A number of the persons consulted (Assonime and IMA) point out that any market manipulation implemented as part of share capital increases would be governed by market abuse regulations. Furthermore, ABI sustains that short selling encourages an efficient price discovery process for both shares and rights offerings, and allows the underwriter to cover the positions assumed. A ban, increasing the risk inherent to share capital increases, could have a negative effect on the market in terms of the number of subscriptions and increase company collection costs.

Lastly, none of the persons consulted – except ICFAS, which claimed an open mind and defined its members as “moderately in favour” – stated that they were in favour of the **introduction of the tick rule**. The persons consulted suggested that the tick rule would result in a loss of market efficiency and liquidity and in operators incurring high compliance costs, versus uncertain benefits, especially in highly fragmented markets where the trading concentration rule does not apply.

The majority of persons consulted were against the introduction of forms of transparency, but a number were in favour of the introduction of some form of reporting (in case including disclosure of aggregate data to the market) and of measures to improve settlement procedures.

Specifically, with regard to **transparency options** (in market dealings), consultation participants consider that such a system would involve considerable costs in terms of:

- reduced short selling activities, also as a result of opportunist conduct to the detriment of short sellers (short squeeze), with negative effects on market liquidity and the price discovery process (Assosim, ABI, Borsa Italiana, ICFAS, IMA). The decrease in short selling could be particularly significant in the period immediately after entry into force of the new regulations, given the consistent legal risk and timeframe necessary for adaptation to the new rules (ABI);
- intensification of bearish trends in security prices. Disclosure to the market of total short sales on securities could also force other investors into selling their securities, resulting in an excessive, unjustified bearish impact on the prices (Assogestioni, Assosim, Borsa Italiana, ABI, ICFAS, IMA). This risk increases when the market is informed of the names of short position holders, due to the herding effect, where those names include market leaders;
- free riding. Asset managers perform strict, costly analyses to identify the overpriced securities, and disclosure to the market would allow other operators to make use of the results of these analyses despite not having incurred the related costs (IMA). This could result in analysis of overpriced securities becoming less convenient;
- transfer of business to other markets. The imposition of transparency measures could result in a transfer of business to other, less transparent markets (the swap markets, particularly CDS, or other derivatives);
- imprecise or distorted information. Transparency rules on aggregate short selling (through a flagging system) could disseminate imprecise information across the market due to the

intermediary's difficulty in verifying the actual coverage of a sell transaction ordered by a customer (ABI, Borsa Italiana). Furthermore, such a system could provide to the market incomplete and potentially misleading information as only short positions – not long positions – are disclosed (ABI), and because short positions held for arbitrage or hedging are not separated from those arising from bearish expectations (IMA).

Of all the consultation participants, only Assonime sees the option of transparency (on net individual short positions) as favourable, i.e. it “appears positive, *if coordinated* with other regulations” (our italics; Auth.). In fact, Assonime emphasises the importance of reaching agreement on European level measures so as to avoid regulatory arbitrage phenomena and excessive costs of compliance with non-standardised measures. The above-mentioned transparency option, according to Assonime, would therefore be desirable only because the major European countries and the CESR seem to be heading in that direction.

With regard to **reporting options (to the supervisory authority) or mixed options**, the persons consulted are for the most part in favour of the introduction of reporting obligations to the supervisory authority, also integrated with a duty to disclose aggregate data to the market. These options are considered by many to facilitate the identification of any manipulative strategies to artificially force a bearish trend by those with significant net short positions in a given security. In addition, these options would allow the market to continue to benefit from the positive effects of short selling.

Nevertheless, ABI and Assosim claim they are also against the adoption of regulatory reporting options, considering them to be as ineffective as those relating to a ban. However, though it considers the measure to be unsuitable, ABI in any event considers it to be more effective and less costly than others and, in the event of its implementation, suggests the adoption of thresholds and deadlines as per provisions on major shareholdings.

Borsa Italiana accepts that the disclosure of net individual short positions to the supervisory authority is an important “*means of identifying situations of tension in securities and of analysing manipulative conduct*”. However, the system implementation costs are considered excessive and there are doubts as to the completeness and accuracy of the information. Borsa Italiana, the only one among the persons consulted, then suggests the adoption of a reporting system based on securities lending transactions, characterised by low compliance costs and simple enforcement. Information on securities lending transactions could be included in the transaction reporting.

With regard to the threshold to be adopted for reporting to the supervisory authority, ISLA and IMA suggest a 0.5% threshold, while ABI and ICFAS would prefer the adoption of thresholds in line with those envisaged for the disclosure of long positions. For aggregate disclosures to the market, ISLA suggests monthly publication whereas ICFAS believes daily publication would be more appropriate. According to ABI the disclosure of aggregate data should be made on reaching the established threshold. Assogestioni considers aggregate market disclosure to be feasible only if it follows the same rules and timing as for long position disclosure.

Lastly, regarding **settlement procedure options**, only certain consultation participants (Assogestioni, ICFAS, IMA) are in favour of adoption. Specifically, Assogestioni agrees with an increase in the margin percentages applied to fail positions and proposes the introduction of charges and fines for

intermediaries with systematic fails. The other persons consulted, however, do not believe that the adoption of measures on settlement procedures would be worthwhile, given that current measures in force seem capable of guaranteeing adequate levels of operating efficiency.

Regardless of the preferred settlement option, the persons consulted in any event consider the adoption of European-level measures crucial. **Harmonised regulations** would both avoid evasive conduct due to regulatory loopholes and reduce operator compliance costs of dealing with different sets of regulations.

In the Position Paper, persons consulted were asked for responses to more specific questions regarding real implementation methods for the different regulatory options. For example, they were asked which entity within a group should be liable for disclosure obligations or whether it would be better to envisage exemptions for certain market operators. The responses provided to these questions will be considered at decision-making stage regarding the final regulatory option.

In the questionnaire subjected to market consultation, those consulted were asked to provide quantitative estimates of the **compliance costs** associated with the various regulatory options. In this context, ABI gathered information through intermediaries, obtained responses from a number of banks similar in terms of size and operations, and from a series of specialist operators from within a single group. ABI emphasises that *“the pointers received vary extensively in relation to the operating size and environment (...), and in relation to the specifics of the systems used”*.

The estimated compliance costs provided by ABI are as follows:

1. Overall ban option: for initial costs the highest value indicated is 2 million euro, whilst recurring costs would be in the region of 1 million euro per year;
2. Option involving a ban on naked short selling: the compliance cost estimates vary considerably, reaching a maximum of 1 million euro per year;
3. Option of a ban if share capital increases are involved: implementation and management costs would be “a few hundred thousand euro”;
4. Implementation of a flagging system: the highest estimate for initial costs is 7 million euro. Recurring costs vary between 1/3 and 1/4 of initial costs;
5. Option regarding transparency on net individual short positions: the estimated initial costs vary between 50,000 euro and 10 million euro, whilst for recurring costs the estimates range from 15,000 euro to 2.5 million euro per year. These values are strictly dependent on the disclosure threshold considered: if a 0.25% threshold were increased to 2% the recurring costs could decrease by almost 2/3.

PART II: ANALYSIS OF THE REGULATORY OPTIONS

1. MARKET FAILURE ANALYSIS

With the recent financial markets crisis, short selling has played a central role in political and academic debate. Fears that this practice could exacerbate the collapse of share prices, intensify market volatility and encourage market abuse forced supervisory authorities throughout the world to adopt a series of measures to restrict short selling, by differing extents.

Temporary measures were therefore adopted to contrast the **negative externalities** that can arise from short selling practices. The conduct of short sellers, in fact, can affect market efficiency levels, increasing its volatility, resulting in sudden drops in share prices and leaving the market open to market abuse. These potential negative effects are even more likely in particularly turbulent and **exceptional market conditions**, situations in which short selling could aggravate the negative market conditions, jeopardising financial stability and companies' ability to raise funds on the market.

The aim now is to define a **permanent regulatory system** to efficiently handle short selling under normal market conditions. For this purpose, analysis of market failure linked to short selling calls for more in-depth consideration that takes into account the **different intentions** of short sellers and the **different contexts** in which they might operate. According to these two variables, in fact, the positive and negative effects of short selling on the market assume different values.

Positive and negative effects of short selling

POSITIVE EFFECTS	NEGATIVE EFFECTS
Price discovery efficiency	Volatility
Liquidity	Settlement risk
	Market abuse

Operators may resort to the practice of short selling for various reasons:

1. Speculative purposes;
2. Arbitrage purposes;
3. Hedging purposes.

Short selling is normally motivated by speculative purposes: investors can sell short because they believe that the security is overvalued and they wish to obtain a profit from the reduction in its listed price.

Short sellers may also operate for arbitrage purposes, simultaneously purchasing and selling associated financial instruments, for example shares and derivatives, so as to exploit any misalignments in the related prices. Furthermore, short selling transactions can be made for hedging purposes. For example, a bank which has sold a put option on a security or who has purchased a convertible bond may hedge them by selling the underlying security short.

If we consider **normal market conditions**, short selling **conducted with these intentions** does not generate negative externalities, but vice versa contributes to the markets' operating efficiency. In particular:

- through speculative short selling, investors in possession of negative information regarding a security that is not owned outright can reveal that information through the sale. In this manner, the discovery capacity of prices would increase, the prices incorporating more information. Short selling therefore helps to improve the **price discovery** process, and consequently has a positive impact in terms of **pricing efficiency**;
- **market efficiency** also increases because short selling helps arbitrage between cash and derivative instruments, facilitating a balance between the respective markets for a given security or for stocks in a particular country;
- short selling for hedging purposes is an important part of operators' **risk management** strategies;
- short selling also helps to improve market efficiency through the higher **liquidity** it brings to the market. In fact, short selling increases the number of potential sellers and future buyers, resulting in an increase in sales volumes and a decrease in transaction costs (measured by the bid/ask spread).

Overall, the empirical literature regarding short selling confirms the presence of these beneficial effects linked to short selling. Specifically, empirical studies indicate that short selling have positive effects both on the price discovery efficiency and on the markets' liquidity.

BOX 1: THE EMPIRICAL LITERATURE

Price discovery efficiency

The empirical studies which analyze the link between short selling and price discovery efficiency confirm the theoretical hypothesis with regard to the relationship between short selling and the price discovery process. Certain empirical analysis shows that the restrictions on short selling lead to a reduction in the price discovery efficiency since they reduce the speed by means of which the information is incorporated in the prices (Boehmer & Wu (2008), Saffi & Sigurdsson (2008), Beber and Pagano (2009)). Other empirical analysis, what is more, shows that the short sellers contribute towards increasing the price discovery efficiency identifying the overvalued companies and selling the related securities short (Karpoff & Lou (2008), Boehmer *et al.* (2008), Bris *et al.* (2007)). Marsh & Niemer (2008) obtain results which differ from the prevailing empirical literature. They analyze, in the period 1 January- 31 October 2008, the impact of the measures on short selling adopted in the various countries so as to deal with the financial crisis and do not find strong evidence of a reduction in the price discovery efficiency following the adoption of restrictive measures. With regard to the effect of the restriction on short selling on the probability distribution of returns on securities, some empirical studies find that this effect is not statistically significant (Charoenrook & Daouk (2005), Marsh & Niemer (2008)).

Liquidity

Empirical studies which analyze the effects of short selling on the liquidity of the markets show that short selling activities increase the supply of liquidity, thereby contributing towards increasing the quality of the markets. All the studies on the subject in fact find that the enforcement of restrictive measures on the practice of short selling leads to a reduction in the liquidity and a consequent increase in transaction costs – gauged by means of the bid/ask spread (Charoenrook & Daouk (2005), Bris (2008b), Boehmer *et al.* (2008), Clifton & Snape (2008), Beber and Pagano (2009)).

Against the positive effects indicated, there are no negative effects linked to short selling, provided the intention is one of the three mentioned above and provided it is conducted under normal market conditions.

With regard to the **risk of excessive volatility**, empirical data does not reveal clear indications as to the effects of short selling on the volatility of returns on securities: while some studies show that short selling reduces the volatility of returns on shares, others suggest the opposite effect (see box 2).

BOX 2: THE EMPIRICAL LITERATURE

Volatility

Empirical analysis on the effects of short selling on the volatility of the returns does not offer clear indications. Some studies show that the enforcement of restrictions on short selling leads to an increase in the volatility of the returns on securities (Charoenrook & Daouk (2005), Boehmer *et al.* (2008)), while other studies reach different conclusions. For example, Shkilko *et al.* (2008) find that short selling exacerbates intra-day volatility in situations involving a liquidity crisis; likewise, Bris (2008b) finds that the restriction measures on naked short selling of some financial securities imposed by the SEC on 15 July 2008 led to a reduction in the intra-day volatility of the securities subject to the measure.

The risk of excessive volatility could emerge with greater intensity, however, when short selling is conducted in **periods of particular market turmoil and crisis**. In such circumstances, in fact, it is more likely that short selling will generate panic and disorientation among operators, creating chain reactions and accelerating bear market trends, with negative effects on market stability.

With regard to **settlement risk**, the consultation confirmed the scenario indicated in the Position Paper, since the current position is generally considered more than satisfactory.

Lastly, the **risk of market abuse**. Short selling may encourage manipulative strategies aimed at unnaturally inducing bearish trends. For example, short sellers may operate by spreading both rumours and signals to mislead a correct evaluation of the securities sold, with the aim of encouraging other operators to sell.

The risk of market abuse, however, is not naturally inherent in short selling practices which, we repeat, are normally conducted merely for speculative, hedging or arbitrage purposes. It is rather the use of short selling practices with the specific aim of perpetrating market abuse that represents pathology of the phenomenon, and which as such should therefore be combated from a regulatory point of view. Moreover, the risk of market abuse is not a prerogative of short selling, but can also be manifested through ordinary security buy transactions.

Empirical literature on market abuse is not particularly extensive (see box 3). The few studies conducted show that this risk appears more evident in correspondence with **share capital increase transactions** and in reference to securities affected by a sharply negative imbalance between buy and sell orders. Specifically, in correspondence with share capital increase transactions, short selling could

be used for manipulative purposes to reduce the price of the securities and render the offer less convenient. In addition, as for volatility and settlement risk, the risk of market abuse is also more likely in exceptional market conditions, which facilitate manipulation to the detriment of other operators.

BOX 3: THE EMPIRICAL LITERATURE

Market abuse

There are few empirical studies aimed at analyzing the conduct of that portion of the market operators who resort to the practice of short selling for the purpose of manipulating the prices of securities and obtaining consistent profits. In this connection, Shkilko *et al* (2008) find that the short sellers significantly increase their activities on those securities which experience a sharp negative imbalance between purchase and sell orders backed by the availability of the securities and confirm that the ability of the short sellers to influence the price of the securities is strengthened by their ability to manipulate the opinions of the markets and the supply of liquidity. A number of empirical studies by contrast analyze short selling activities in correspondence with share capital increase transactions, since in such circumstances the short selling could be used for manipulative purposes, in order to reduce the price of the securities and make compliance with the offer less advantageous. In this connection, Safieddine & Wilhelm (1996) look at the evolution of short selling activities in correspondence with seasoned equity offerings¹ in the United States and assess the effects of the introduction of rule 10b-21². They find that: (i) between the date of the announcement of the offering and its execution, the short selling activities increase significantly, reaching far higher levels than those prior to the announcement; (ii) these activities decrease following the introduction of rule 10b-21. Looking into the purposes which force short sellers to intensify short selling activities in correspondence with share capital increases, the authors find evidence of the fact that these purposes are mainly manipulative.

An important conclusion emerges from the analysis, which becomes the starting point for defining better regulatory strategies on this subject. **Short selling per se does not appear to be an abusive practice. If performed for speculative, hedging or arbitrage purposes and under normal market conditions, it helps to improve market efficiency, facilitates the price discovery process and increases market liquidity. These benefits are not felt in pathological situations, such as when short selling is used as a means of perpetrating market abuse, or in exceptional market conditions, for example during market crises. This conclusion must guide the decision on regulatory options to be adopted for permanent regulation of short selling.**

¹ The seasoned equity offerings are share capital increases addressing the market, with or without right options, subsequent to IPOs.

² This rule, introduced in 1988, prohibited the use of shares purchased at the offering price for hedging short positions created after the announcement and before the start of the offering.

2. THE CHOICE OF REGULATORY OPTIONS

The market failure analysis performed above and the examination of contributions from those participating in the consultation allow us to further sift the choice of regulatory options for short selling analysed in the Position Paper.

It should be remembered that the Position Paper identified regulatory options as follows:

➤ **restrictive regulatory options:**

1. restriction on all short selling activities (both naked and covered);
2. restriction on just naked short selling;
3. restriction on short selling activities under exceptional market circumstances;
4. restriction on short selling of shares subject to share capital increases;
5. tick rule.

➤ **transparency regulatory options:**

1. transparency options “in a strict sense”:
 - 1.1 on aggregate short selling;
 - 1.2 on individual significant net short positions;
2. reporting options on individual significant net short positions;
3. mixed reporting and transparency options “in a strict sense”:
 - 3.1 disclosure to Consob of significant net short positions and disclosure to the market by Consob of the aggregate data;
 - 3.2 reporting to Consob and disclosure to the market of significant net short positions, with provision of different thresholds (two level system);
 - 3.3 transparency/reporting on securities lending activities.

➤ **regulatory options concerning settlement procedures for securities transactions.**

The above analysis identified the market failures that regulatory action aims to correct. We have said that, provided it is not used for manipulative purposes and if market conditions are normal, short selling improves market efficiency, increases liquidity and improves the efficiency of the price discovery process.

Regulatory options that impose bans of a more or less restrictive nature on short selling therefore do not appear suited to correcting the market failure identified. Banning short selling practices to combat its potential use in market manipulation would generate costs higher than the related benefits. In other words, to contrast the fraudulent use of short selling or to counteract its negative effects in abnormal market conditions, a complete ban is not necessary, but rather direct intervention on its more harmful manifestation (see Gruenewald et al. (2009)).

Consequently, the following **regulatory options involving bans will not be taken into consideration** in future as possible candidates for permanently regulating the short selling phenomenon:

- restriction on all short selling activities (both naked and covered);
- restriction on just naked short selling;
- tick rule.

Vice versa and consistent with the market failure analysis, the option regarding Consob's **power to intervene in exceptional market conditions** will in future be considered as a potential permanent solution, as it seems suited to correcting a number of potential undesirable effects associated with short selling practices.

With regard to the option of a **ban where share capital increases are involved**, it has been mentioned that certain empirical studies have shown a risk of market abuse in connection with short selling conducted in correspondence with such increases. However, as mentioned in the Position Paper, *“one is aware of the fact that short selling of shares of companies subject to share capital increases could, under normal conditions, permit greater efficiency in the formation of the prices, both of the shares and purchase options relating to said capital increase. As a point of fact, the possibility of setting up arbitrage transactions by means of the sale of shares and the simultaneous purchase of the corresponding rights, in the event that the shares are overvalued or that the purchase options are undervalued, permits the realignment of the values and, therefore, a reduction in the distortions of the price dynamic”*.

Given these observations, and also taking into account the opinion against this option expressed by most of the persons consulted, it is considered that this can be excluded from the potential permanent regulatory options. Amongst other things, it has to be considered that the risk that short selling is used for manipulative purposes in correspondence with share capital increases is more likely to arise in market situations characterised by particular turmoil. In this respect, it is believed that the option of Consob's **power to intervene in exceptional market conditions** in any event allows Consob to take effective action through specific measures to regulate short selling conducted in correspondence with share capital increases where there is a particular need to contain the risk of market abuse associated with such transactions.

In general, it is considered that, except in emergency market situations, the measures potentially most suited to contrasting the risk of market abuse are transparency measures, combined with efficient settlement procedures. The option of regulating transparency via the definition of disclosure requirements, in fact, as also stated in the Position Paper, aims to reduce the risks of market abuse and instability associated with the short selling practices, therefore allowing the market to benefit from the positive effects of short selling.

A number of transparency options were identified in the Position Paper, some nevertheless appearing less suited to combating market abuse due to the type of phenomenon subject to disclosure. Specific reference is made here to the **transparency option regarding aggregate short selling** and the **mixed option regarding securities lending**.

The first of these options envisages disclosure to the market of aggregate short sales for each security through implementation of a flagging system. In this case, the disclosure of **aggregate data** would not provide supervisory authorities with the information necessary to match suspect positions to an individual operator³. Furthermore, the information obtained by adopting a flagging system may be inaccurate, due to the complexity of the system and the difficulty in monitoring the accuracy of data provided. Lastly, short selling can also be implemented for hedging or arbitrage purposes, and therefore does not necessarily indicate a downward turn in the security price. A mere knowledge of short sales

³ This would be the case if aggregation was not performed by the supervisory authority.

without accompanying information on the long positions of the seller on that security is not enough to effectively identify signs of market abuse.

Even the combined transparency-reporting option on securities lending seems inadequate to effectively contrast market abuse because, as mentioned in the Position Paper:

- *the operators access securities lending for different reasons and not necessarily for the purpose of ensuring the hedging of short selling; accordingly, the information relating to securities lending activities could provide signals which are not always consistent with the effective bearish pressure of the market;*
- *the information on securities lending activities makes it possible to fully assess just covered short selling, but is not effective for monitoring the abnormal aspects potentially associated with naked sales.*

Indeed, it is still to analyze the following options:

1. transparency options “in a strict sense” on individual significant net short positions;
2. reporting options on individual significant net short positions;
3. mixed reporting and transparency options “in a strict sense”:
 - 3.1 disclosure to Consob of significant net short positions and disclosure to the market by Consob of the aggregate data;
 - 3.2 reporting to Consob and disclosure to the market of significant net short positions, with provision of different thresholds (two level system).

With regard to these options, the Consob Position Paper formulated the following working hypotheses (page 27, Position Paper on Short Selling):

CONSOB working hypothesis:

“With regard to the current state of play, the Consob reporting option regarding individual significant net short positions appears preferable with respect to the transparency options “in a strict sense”. Nevertheless, in light of the observations made so far, it is believed that these regulatory options may be assessed with greater accuracy over time. In fact, taking into account the uncertainties associated with the effects of a transparency regime “in a strict sense” on the conduct of the operators, an improved awareness of the phenomenon of short selling, via analysis of the data disclosed to Consob by operators, if the option reporting was effectively implemented, could be essential for identifying the optimum disclosure set relating to the short positions held by the operators to be possibly disclosed to the market. In light of the potential benefits and costs, the adoption of the option involving reporting to Consob on the individual significant net short positions is considered desirable”.

The position expressed by Consob met with the overall approval of the persons consulted. Most consultation participants were in favour of the reporting option, also integrated with disclosure to the market of aggregate data, whereas most were against the idea of transparency in the strictest sense. As the key objective of transparency regulation is to combat the manipulative use of short selling practices, the option of reporting to the supervisory authority seems that most likely to achieve the objective. It

would then need to be assessed whether additional market disclosure requirements might prove useful in improving market efficiency.

In the light of these observations, regulatory options that in any event envisage reporting to the supervisory authority seem preferable to options merely envisaging forms of market transparency. Therefore the **option of transparency in the strictest sense on significant net individual short positions** can be excluded from the list of potential permanent regulatory options since it is absorbed by the mixed option of reporting to Consob and market disclosure of significant net individual short positions on the basis of different thresholds (a two-level system).

The transparency options that therefore seem best suited to permanently regulating the short selling phenomenon are:

1. reporting options on individual significant net short positions;
2. mixed reporting and transparency options “in a strict sense”:
 - 2.1 disclosure to Consob of significant net short positions and disclosure to the market by Consob of the aggregate data;
 - 2.2 reporting to Consob and disclosure to the market of significant net short positions, with provision of different thresholds (two level system).

Lastly, with regard to options concerning settlement procedures, given that the current situation is more than satisfactory, as confirmed by the persons consulted, any further study of such options will be covered in the hoped-for European harmonisation process.

CONCLUSIONS

This document has illustrated the main comments received in response to the Position Paper on short selling published on 27 May 2009. Given these comments and a more detailed analysis of market failure generated by short selling, the list of regulatory options initially analysed in the Position Paper can be reduced by excluding those for which the estimated costs are definitely higher than the potential benefits gained in combating short selling-related market failure.

The remaining options, identified in this document, will be subjected to a more detailed cost-benefit analysis when current action being taken at European level to identify harmonised regulatory options is finalised, also taking into account the harmonisation content and any margin for discretion left to national regulation.

In fact, a correct cost-benefit analysis of every possible option cannot be performed without information on measures in force in other countries, as the effectiveness of the various options relies heavily on the current level of harmonisation.

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