CONSOB *POSITION PAPER* ON *SHORT SELLING**

27 May 2009

Interested parties are welcome to submit their comments to the position paper, in English or Italian, and send their responses at the following address:

C O N S O B
Divisione Mercati
Via G. B. Martini, n. 3
00198 ROME - ITALY

or on-line via SIPE – Integrated System for External Users

Comments should reach us by 15 July 2009.

* This translation has been prepared for information purposes only. It is not intended to be nor does it constitute an official version of the text. For all legal purposes reference should be made to the Italian text.

CONSOB *POSITION PAPER* ON *SHORT SELLING*

1. Introduction page 2

2. Short selling: definitions and analysis of its effects on the market page 4
   2.1 Definitions page 4
   2.2 Purpose and analysis of the effects on the market page 4
   2.3 Empirical literature on the effects of short selling page 7
   2.4 Conclusions page 10

3. Regulatory options page 12
   3.1 The regulatory options identified by Consob page 12
      3.1.1 Restrictive regulatory options page 14
      3.1.2 Transparency regulatory options page 20
      3.1.3 Regulatory options regarding settlement procedures page 26
   3.2 Exemptions page 29

Bibliography page 30
Attachment: Questionnaire page 32

1. Introduction

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. These measures were adopted so as to curb brusque downward corrections in listed prices and ensure an orderly price formation process, at the same time reducing the possibilities of market abuse.

The measures adopted in the various countries differ with regard to subject matter and timescale. Nearly all the Authorities have temporarily prohibited short selling (SEC, *Ontario Securities Commission*, AMF, FSA); only some countries – such as the UK and France – have laid down disclosure obligations for the operators.

In this context, Consob has intervened adopting the first measure on 22 September 2008 (effective from the following day) which prohibited short selling of shares of banks and insurance companies listed and traded on Italian regulated markets, not backed by the availability of the securities from the time of the order until the date of settlement.

On 1 October 2008, a more restrictive measure was adopted, which provided for that the sale of shares of financial companies had to be backed not only by the availability but also by the ownership of the shares. This restriction was then extended as from 10 October to all listed securities. On 30 December 2008, Consob once again took action (by means of an additional measure effective from 1 January 2009), confirming the validity of the previous system for financial securities and for shares of companies subject to share capital increases, and reinstating the restriction on sales not backed by the availability for other securities. This latter measure was extended until 31 May 2009.

Taking into account the subsequent market evolution, on 27 May 2009 Consob amended the temporary restriction regime, limiting its application, for all securities, to just sales not backed by the availability of said securities at the time of the order. With regard to share capital increases, shares issued by companies subject to share capital increases as of the date the resolution came into force continue to be subject to – until the day of delivery of the shares deriving from the same – the provisions pursuant to point 2 of Resolution No. 16813 dated 26 February 2009, in accordance with which the sale must be backed by both the availability and ownership of the securities from the time of the order until the date of settlement.

The measures taken by Consob up to now are temporary and represent a response to the recent exceptional conditions on the financial markets. Nevertheless, Consob is aware of the need to define a policy on short selling and, more generally, on the phenomenon of short positions (see section 2.1), irrespective of the market conditions. This need is also strongly felt by other Supervisory Authorities, which are also in search of permanent solutions. In particular, at European level, the desire to follow a harmonized approach emerges, which could draw together the regulations on short selling in force in the various countries.

The purpose of this position paper is to start a debate with the market on short selling, so as to identify the possible regulatory options and submit them for preliminary analysis of the related costs and benefits, as part of a regulatory impact analysis approach. The analysis of the several options which we hereby recommended and on which we request comments and opinions, is economic in nature. With regard to the assessment of the outcome of the consultation, account will be taken of any evolution in the legislative framework also in relation to the initiatives underway at supranational level.

This paper is structured as follows: Section 2 contains a definition of the short selling and short positions, a description of the main purposes they are used for, and identifies the related positive and negative effects in light of the main empirical literature on the subject. Section 3 identifies the various regulatory options on the subject, and a costs-benefits analysis is performed for each one. In conclusion, the attachment contains a questionnaire which is intended to be used to gather the comments of the operators on this subject.

So as to encourage a more methodical assessment of the answers provided, you are strongly recommended to reply to this consultation, in any event using the questionnaire, supplemented by additional information and evaluations considered useful.

2. Short selling: definitions and analysis of its effects on the market

2.1 Definitions

- **Short selling**

Short selling shall mean the sale on the market of securities whose "funding" has not been ensured in advance.

There are two types of short sale, covered and naked. Covered short selling transactions are those backed by the securities lending: the seller borrows a number of shares equalling the number of shares which he intends to sell short, so as to ensure the delivery to the purchaser. Then, he purchases the same quantity of shares on the market so as to return them to the lender. The lender may request either cash or financial instruments as collateral. If the collateral is represented by financial instruments, the lender receives commission from the seller, but if the collateral is represented by cash, the lender pays the seller interest at a rate lower than the market one.

Conversely, naked short selling transactions are not backed, at the time of the order, by securities lending, therefore the seller must search the market for shares to deliver to the purchaser, in order to settle his position. The coverage can be made by means of securities lending activities or via a purchase, off or on the market. Naked short selling, therefore, gives rise to a high risk of non-delivery of the securities on the settlement date contractually envisaged. This risk becomes real if the securities are bought on the market during the days after the execution of the selling order.

- **Short positions**

Short positions on a security may be undertaken not only by selling it short, but also by using derivative instruments which give rise to the obligation or the right to deliver the underlying instrument by a certain date.
All the short positions which an operator can undertake on a security, both by using derivative instruments and via short selling activities, define the **gross short position** on the security. The **net short position** is obtained by subtracting the sum of the long positions[1] on the security from the gross short position, undertaken also by means of derivative instruments.

2.2 Purpose and analysis of the effects on the market

- **Purpose**

Operators may resort to the practice of short selling for various reasons.
Short sellers may for example deal for **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. Actually, by adopting specific investment strategies, short sellers could achieve a profit even in case of an increase in the security's listed prices. For example, investors may adopt strategies that profit from changes in relative prices, undertaking a long position on the security they consider undervalued and short selling that which they consider to be overvalued; in this case, the investor's profit will depend on the related performance of the two securities and not just on the return on the security sold short.

[1] Long position shall mean a position which benefits from upward fluctuations in the price of the security or the underlying instrument; it may be achieved both by purchasing said shares and by the use of derivatives which have shares as their underlying instrument.

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.

- **Positive effects of short selling**

Despite the practice of short selling being somewhat controversial and subject to considerable criticism, economic literature on the subject supports the idea that it usually contributes towards the efficient functioning of the markets. In particular, it is believed that short selling activities bring substantial benefits to the market, improving the price discovery efficiency and increasing the level of liquidity.

Price discovery efficiency

Short selling activities enable investors holding negative information on a security which is not available to them to reveal this information through the sale. Accordingly, it contributes to the accurate valuation of the stocks and speeds up the process of reduction of the prices of overvalued securities, which will most rapidly incorporate any bad news.

Consequently, any restrictions on short selling may lead to a temporary overvaluation of the listed prices, since these incorporate just the expectations of the bulls and not those of the bears who do not possess the security as well, thereby reducing the price discovery efficiency and slowing down the speed of price adjustment of overvalued securities.

The presence or otherwise of restrictions on short selling activities could also affect the probability distribution of returns on the securities. On the one hand, restrictions on short selling, inducing bear investors to exit the market, could increase the probability of positive returns much higher than the average and reduce the probability of extreme negative returns[2].

On the other hand, restrictions on short selling could also lead to the opposite effect, and increase the probability of extreme negative returns. This is because in case of restrictions, when the negative information becomes public, there will be adjustments to the listed prices much sharper in the event of negative news rather than positive news, since negative news has not been previously incorporated in the prices[3].

Liquidity

Short selling activities enhance the liquidity level on the market, since they increase the number of potential sellers (and future purchasers). This translates into an increase in sales volumes and a reduction in transaction costs, through a reduction in bid/ask spreads. Any restrictions on short selling activities could therefore increase the level of the transaction costs and push investors to request greater returns, causing a reduction in share prices.

[2] See Miller (1977).
[3] See Diamond and Verrecchia (1987).

- **Negative effects of short selling**

Short selling activities are not only ascribed positive effects, but negative ones as well. In particular, it is believed that they can have a negative effect on the stability of the markets, which can be used for manipulative purpose and which increases the settlement risk.

Market instability

Short selling can be of such an extent and speed that it leads to a significant and sudden reduction in the prices of the securities, creating confusion on the markets and increasing the level of volatility of the prices both over the very short and the short term. In fact, consistent and rapid short selling may create concerns and uncertainty on the market, discouraging intervention contrasting orders by potential purchasers. This risk is even greater in situations of particular tension on markets, where it is more probable that short selling will generate panic and disorientate the operators, creating chain reactions and therefore contributing towards exacerbating the bearish trend of the market.

The risk of instability could be higher in the event of sales not backed by securities lending, which, in principle, may be quicker and more consistent than covered sales. In fact, in the event of covered short selling, the covering request could limit both the speed of the transaction (given the need to hedge oneself) and its consistency (limited by the ability to borrow the securities). Nevertheless, the greatest “danger” of naked short selling mainly depends on the “settlement procedures” existing (for example: settlement cycle, existence of any penalties, buy-in procedures), since these procedures may establish the last day within which the securities sold short must be delivered and, within this interval, the variables which influence the decision of the operators to deliver the securities sold[4].

Market abuse

Short selling may encourage manipulative strategies aimed at inducing, in an unnatural manner, bearish trends. For example, short sellers may operate, at the same time spreading rumours and disclosing misleading signals with regard to the right evaluation of the securities subject to sale, so as to encourage the other operators to sell.
This risk is greater when the short sale transactions are consistent and take place within short spaces of time, potentially more probable for sales not backed by securities lending.

Settlement risk

Short selling exaggerates the integrity risks of the market since, with the intensification of this type of transaction, the difficulties of the operators increase with regard to procuring securities sold short over time and therefore the fail[5] probability in the settlement process and their duration increases. Furthermore, the probability of failure to deliver in a strict sense increases. Obviously, this risk arises with reference to short selling transactions not backed by securities lending.
The presence of a consistent settlement risk may alter the correct functioning of the markets, increasing transaction costs and reducing the trading levels.
Clearly, the entity of the settlement risk mainly depends on the settlement procedures in force.

---

[4] See section 3, part 3.3.3 with regard to the settlement procedures.
[5] Fail shall mean the failed delivery of the securities on the intended settlement date.

2.3 Empirical literature on the effects of short selling

Overall, the empirical literature regarding short selling confirms, albeit with a number of exceptions, the presence of 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.

However, the empirical information does not reveal clear indications on the effects of short selling on the volatility of the returns on securities: while some studies show that short selling reduces the volatility of returns on shares, others highlight an opposite effect. Nevertheless, the studies which disclose a reduction in volatility under circumstances prohibiting short selling, are based exclusively on data reported during the day.

With regard to the risk of market abuse, the empirical studies analyzed show that this risk appears to be particularly evident in correspondence with share capital increase transactions and with reference to securities which experience a sharp imbalance, negatively, between purchase and sell orders.

In conclusion, there are a number of empirical studies which analyze the effects resulting from the establishment of a transparency regime on short selling[6]. In general, these studies show that, in the presence of a transparency regime, the announcement of short selling on a security is interpreted as a negative signal by the market, which reacts by selling the security and emphasizing the reduction of its listed price.

BOX: EMPIRICAL LITERATURE ON THE EFFECTS OF SHORT SELLING

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 (Saffi & Sigurdsson (2008), Boehmer & Wu (2008)). 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)).

[6] Even before the current crisis, certain countries envisaged disclosure obligations on short selling transactions. This made it possible for a number of scholars to empirically analyze the consequences of this system.

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)).

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))[7], 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.

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 offerings[8] in the United States and assess the effects of the introduction of rule 10b-21[9]. 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.

---

[7] Charoenrook & Daouk (2005) consider the daily and monthly volatility, Boehmer *et al*. intra-day volatility .

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

[9] 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.

[10] The Australian regulations envisage that all the sales orders which take on the form of short sales be identified as such at the time of their issue; straight after their execution, the ASX discloses the details of the transactions to the brokers, electronically and in real time.

[11] The Nasdaq receives the data from the market makers on short positions monthly, aggregates it for each security and discloses it outside (also via the Wall Street Journal and the New York Times), so as to divulge the information on the aggregate short positions for each share monthly.

Henry & Koski (2008) also look into the purposes of short selling activities in correspondence with seasoned equity offerings, using data relating to a sample of offerings achieved in the United States in the period 2005-2006, and find confirmation of the hypothesis of market manipulation.

Effects of a transparency regime

Some empirical studies assess the effects resulting from the enforcement of a transparency regime on short selling. In general, these studies highlight that, in the presence of a transparency regime, the announcement of short selling on a security is interpreted as a negative signal by the market, which reacts by selling the security and emphasizing the reduction in its listed price. For example, Senchack & Starks (1993), with reference to the shares listed on the NYSE and on the ASE, find that the prices of the shares which experience an unexpected increase in short selling drop significantly following the announcement. Furthermore, the authors find that the returns are all the more negative the higher the short interest level is and that the phenomenon of the reduction in the listed prices is not so sharp for the companies with listed options, for whom short selling can also be adopted for hedging purposes.
Aitken *et al*. (1998) study the consequences of regulations based on transparency in Australia, were short selling transactions are communicated shortly after their execution[10]. The authors demonstrate that the announcements of short selling lead to significant reductions in the prices of the securities sold, confirming the hypothesis that short selling represents bad news for the market. Furthermore, the authors find that short selling taking place with a high probability of being carried out for hedging purposes is more unlikely to lead to a negative reaction of the markets.
Desai *et al*. (2002) analyze the link between the level of short selling and the returns on securities listed on the Nasdaq between June 1988 and December 1994[11]. The authors find that the securities subject to intense short selling activities experience consistent reductions in the listed prices, bearing witness to the fact that short selling represents a negative signal for the market.
Also Gintschel (2001), using the data relating to companies listed on the Nasdaq in the period 1995-1998, finds that the securities subject to consistent and unexpected short selling activities experience significant reductions in prices following the announcement.

- **The effects of the restrictive measures on short selling in Italy and in the UK**

Consob recently carried out statistical analysis aimed at assessing the effects of the first measures prohibiting short selling adopted to deal with the crisis[12]. The results of the analysis disclose the following:

- The trend in share prices was negative and in any event similar to that in other countries. With regard to the probability distribution of the returns, in relation to industrials a reduction took place in the probability of obtaining highly negative returns. By contrast, in relation to bank securities, an increase was noted in the probability of observing both extremely negative returns and extremely positive ones, due to the increase in volatility consequent to the climate of great turbulence within the markets.
- The restrictive measures contributed towards reducing the speculative activities of day traders, operators who close positions by the end of the session, with the aim of generating profits linked to changes during the day in the prices of securities.
- After the first Consob resolution (effective from 23 September 2008) trading activities on bank securities fell significantly, only to then return to levels similar to the previous ones. The same evidence emerges with reference to the period after the second resolution (effective from 1 October 2008). However, after the third resolution (effective from 10

[12] These are measures which came into force as of 23 September, 1° October and 10 October.

October) trading on both financial securities and industrials fell to levels considerably lower than the average ones in the period January - August 2008 and the period prior to the Lehman Brothers crash.

- Following the last resolution (effective from 1 October 2008) one can observe a significant increase in the differentials between the purchase and sale prices on the spot market for all the securities.
- The restrictive measures contributed towards the reduction of the failed delivery of the securities, especially for orders attributable to Italian brokers. By contrast, no significant changes were seen in fails attributable to foreign brokers[13].
- The analysis highlights a shift in operations from the cash market to the derivative market, even if this shift is not considerable in size.

Overall, the results of the analysis disclose how the enforcement of the restrictions on the practice of short selling has not only brought benefits but also costs for the market. In fact, even if the speculative activities have decreased and the fails been downsized, the restriction seems to have contributed towards reducing the liquidity on the market and increasing the transaction costs and the volatility of the returns, without however managing to slowdown the descent of share prices.

On 18 September 2008, the FSA temporarily prohibited short selling on securities in the financial sector. In February 2009, the same FSA published the result of statistical analysis carried out by the same Authority for the purpose of testing the effects resulting from the enforcement of the restriction. The analysis carried out revealed a number of important results:

- The performances of the securities subject to the restriction did not improve significantly. In detail, the average returns of the securities subject to the restriction appear to be in line with those of the excluded securities, both before and after the enforcement of the restrictive measures. Only in the 15 days immediately subsequent to the restriction, there was an essential improvement noted in the performances of the financial securities.
- Straight after the introduction of the restriction, the volatility rose significantly on the entire market only to then decrease to pre-restriction levels. With regard to the change in the volatility of the shares in the financial sector with respect to the market, the results of the analysis are inconclusive.
- The trading volumes relating to financial securities increased straight after the introduction of the restriction, only to then subsequently decrease. Transaction costs, gauged by the bid/ask spread, increased after the restriction for all the securities, with the greatest increases seen for financial securities.

With regard to the matters revealed by the analysis, the enforcement of the restriction has not brought any significant benefits to the market, either in terms of reducing the volatility, or in terms of improving the performances of the securities, while it did lead to a reduction in the liquidity and growth in the bid/ask spread.

2.4 Conclusions

The previous analysis reveals elements useful for the definition of an efficient regulatory solution with regard to short selling. Studies on the subject suggest that short selling improves the quality of the financial markets, increasing the level of liquidity and encouraging the price discovery process.

[13] The statistics on fails refer to the counter value of the newly created fails relative to the correspondent counter value of the trading.

The effects produced by this practice on the market stability and therefore on the intra-day volatility cannot be assessed unequivocally, given the divergence of the empirical results obtained. Doubts remain also with regard to the effects which a transparency regime on short selling could have on the conduct of the market operators; in this connection, the empirical studies analyzed show that the disclosure to the market could speed up the processes reducing the listed prices of the securities subject to consistent short selling.

Conversely, it appears important to concentrate attention on two further problems associated with the practice of short selling, the settlement risk and the risk of market abuse, which may be extremely detrimental to the correct functioning of the financial markets and the orderly course of trading.

A careful assessment of all these elements is preparatory to the identification of the possible regulatory options to be examined with regard to short selling, also in relation to the definition of the objectives to be pursued, the possible beneficiaries of the measures and the related spheres of application.

3. Regulatory options

In this section, various regulatory options regarding short selling will be presented, for the purpose of launching a discussion with the market and identifying a suitable solution for disciplining the phenomenon permanently. The costs and benefits potentially associated with each option will be indicated and analyzed.

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. In any event, the regulatory solution identified will have to exploit the margins for manoeuvre inherent in the recommendations from supranational organizations to the maximum.

3.1 The regulatory options identified by Consob

The regulatory options on which a discussion with the market is desired, are divided up into three types, according to the related aims:

1. restrictive regulatory options, which aim at imposing restrictions, more or less stringent, on short selling activities;
2. transparency regulatory options, which impose disclosure obligations on the operators for short selling transactions entered into or net short positions held. These options are broken down into:
   - 1.1 transparency options “in a strict sense”, which impose disclosure obligations on the operators vis-à-vis the market;
   - 1.2 reporting options, which identify the Supervisory Authority as the party who will receive the information;
   - 1.3 mixed reporting and transparency options “in a strict sense”;
3. regulatory options concerning settlement procedures for securities transactions.

In general, the three regulatory option categories are not necessarily alternative to each other.

The **restrictive regulatory options** which are analyzed are as follows:

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.

The difference between these regulatory solutions lies within the objective sphere of the restriction. In detail, while the difference between the first two options lies in the purpose of the restriction, the subsequent three options differ due to the circumstances which bring about the restriction.

While the first option prevents all the short selling transactions (both covered and naked), the second prohibits just naked short selling. The solutions pursuant to points 3) and 4) establish the impossibility of selling short in the presence of exceptional market situations (option 3) or in concurrence with share capital increase transactions (option 4); finally, the tick rule (option 5) envisages that short selling cannot be made when the listed prices of the securities are falling. In abstract, each of the options 3, 4 and 5 could distinguish between the all-out restriction and the restriction of just naked short selling. In conclusion, while option 3 is exceptional, all the other options are permanent.
These solutions aim at eliminating (the first) or reducing (the others) the risks associated with short selling transactions.

Transparency regulatory options “**in a strict sense**” have the aim of making potentially significant information available to the market. In fact, short selling, if not made public as such, does not permit investors to become aware of what part of the sell orders on a security is represented by short selling and what part by contrast is represented by “ordinary” sales. This information could be useful to the investor and affect his trading strategies, increasing price discovery efficiency. The enforcement of transparency duties on short selling / short positions is therefore justified on the basis of the hypotheses that these represent a **signal** for the investors, which the latter use for defining their own purchase/sale strategies[14].

Transparency options "in a strict sense” which are considered further on, are as follows:

1. transparency on aggregate short selling;
2. transparency on individual significant net short positions.

These regulatory options differ with regard to the subject matter of the disclosure, which may alternatively be represented by:
- aggregate short selling, in other words the amount of the short selling transactions present at a specific time on a certain security;
- individual significant net short positions, or net short positions which each operator holds on each security, when they exceed specific pre-established thresholds.

In addition to the transparency options “in a strict sense”, a Consob reporting option is analyzed along with a number of mixed reporting and transparency options.

The **reporting option** involves disclosure to Consob of the individual significant net short positions.

[14] According to some, a high level of short interest can be considered to be a bullish signal, since it is indicative of latent demand: “*a commonly held idea is that the larger the short interest, the more likely that a stock will go up*. *That’s because shorts eventually will buy back the stock, thereby putting upward pressure on its price*” (Epstein (1995)). Alternatively, the presence of short selling on a security can be interpreted as a bearish signal because it is indicative of the possession by informed investors of bad news on the security (Diamond & Verrecchia (1987)). As clarified in the first part of the paper (section 2.3), this second hypothesis is confirmed by a number of empirical studies which analyze the effects of a transparency regime on short selling. It should also be emphasized that short selling does not represent an indicator of the value of the securities it covers if it is carried out, for example, for hedging purposes (Brent *et al*. (1990)). In this case, awareness of the amount of the short selling transactions should not affect the investors’ choices.

The **mixed reporting and transparency options** "in a strict sense" which are considered are the following:

1. disclosure to Consob of significant net short positions and disclosure to the market by Consob of the aggregate data;
2. reporting to Consob and disclosure to the market of significant net short positions, with provision of different thresholds (two level system);
3. transparency/reporting on securities lending activities.

The first two options are mixed in a strict sense, since they envisage different disclosure obligations vis-à-vis Consob and the market. The third is in fact a generic option, since it includes both the transparency options "in a strict sense" and the reporting options.

All the transparency options, via the definition of the disclosure duties, aim to reduce the risks of market abuse and instability associated with the practice of short selling, therefore permitting the market to benefit from the positive effects associated with short selling. Furthermore, transparency options "in a strict sense", as already specified, via the sharing of data on short selling/short positions with the market, aim to improve the information available to the market, so as to increase the price discovery efficiency.

In the event of aggregate short selling transctions, the party who is the recipient of the disclosure obligations is the broker, while in the case of individual significant net positions it is the holder of the position. Information on securities lending transactions should by contrast be disclosed by the broker who has lent the securities.

In conclusion, a number of **regulatory options concerning the settlement procedures for** transactions on securities (duration of the settlement cycle, buy-in, etc.) are presented, which aim at regulating the phenomenon of failed deliveries within the sphere of the settlement process and consequently the short selling not backed by securities lending.

The options analyzed differ not only due to the benefits associated with the same, but also in relation to the related costs. The aim of the analysis which follows is to identify –for each regulatory option – the related costs and benefits expected, which are assessed in relation to the so-called "zero option", or the regulatory option of non-intervention, which, if implemented, would effectively reinstate the regime existing before the adoption by Consob of the temporary restrictive measures.

3.1.1 Restrictive regulatory options

1. Restriction on all short selling (naked and covered)

A possible regulatory solution involves permanently imposing the restriction on all short selling, also on those sales backed by securities lending.

The adoption of a similar solution would make it possible to cancel all the effects, both positive and negative, associated with the practice of short selling. In particular, it is possible to identify the following benefits associated with the regulatory option:

- cancellation of the risks of instability on the markets associated with the practice of short selling;
- cancellation of the risk of market abuse via short selling;

- write-off of the fails associated with short selling.

Faced with these benefits, the restriction option would involve significant costs, in terms of:
- reduction of the price discovery efficiency;
- reduction of the liquidity and consequent increase in transaction costs;
- reduction in operations on the spot market with the transfer of the same to the derivative market; in fact, the market operators could elude the restriction and continue to speculate on the reduction in the price of the securities by operating on derivative instruments (for example: purchasing a put option or selling a future), thereby reducing the activities on the spot market and moving them to the derivative market;
- reduction in operations at the domestic level to the benefit of foreign markets and operators. The restriction could be eluded also by operating on foreign markets where the restriction is not in force; furthermore, the operators could decide to use financial intermediaries not subject to the direct supervision of the Authority which imposed the restriction as brokers, preferring brokers resident in other countries in relation to whom enforcement activities are more difficult.

Additional costs could be those relating to compliance (set-up costs) which the companies will have to incur in an initial phase for the purpose of adapting to the new regulations (in particular, costs for consolidating the IT systems and the procedures already existing). Moreover, opportunity costs should be considered, or rather costs in terms of lost profits due to the reduction in trading activities (foregone profits).

Lastly, this option would also involve direct costs for Consob, linked to monitoring and enforcement activities.

CONSOB working hypothesis:

In light of the analysis carried out in the first section of the position paper regarding the effects of short selling identified by the empirical studies examined, it is believed that the benefits deriving from the regulatory option prohibiting short selling are not enough to offset the related costs.

As a point of fact, empirical literature on the subject confirms the existence of positive effects associated with short selling, in terms of an improved price discovery efficiency and greater liquidity, while it is more vague (or silent) with respect to the significance of the negative effects associated with this practice.

In detail, with regard to the risk of instability of the markets, the empirical data does not reveal clear indications as to the effects of short selling on the volatility of the returns on securities: while some studies demonstrate that short selling transactions reduce the volatility of the returns of shares, other highlight a contrary effect. Nevertheless, the studies which highlight a reduction in the volatility under circumstances prohibiting short selling, in contrast to the studies which indicate the contrary effect, are exclusively based on intra-day data. Also with regard to the risk of market abuse, the economic literature does not offer precise indications, unless it is in reference to “specific”, transactions such as share capital increases.

In light of these observations, it appears that the enforcement of a restriction would translate into a sure loss in terms of liquidity and price discovery ability and in the achievement of benefits not clearly “assessed”. Certainly, an essential benefit would be obtained in relation to the writing off of the settlement risk associated with short selling. However, this result does not appear to justify the enforcement of a restrictive measure such as permanent restriction on all short selling.

In light of the benefits and costs potentially associated with this regulatory option, it is considered preferable not to proceed with its adoption.

2. Restriction on just naked short selling

This regulatory option involves the enforcement of a restriction on all short selling transactions not backed by securities lending at the time of the order (naked short selling).
The adoption of this solution would make it possible to limit the risks associated with short selling without therefore giving up the related benefits entirely. In particular, the restriction on naked short selling would lead to:

- a reduction in the risk of instability on the markets associated with the practice of short selling;
- a reduction in the risk of market abuse by means of short selling;
- the write-off of the fails associated with short selling.

As already indicated previously, both the risk of instability (whose existence is in any event questioned by empirical literature on the subject) and the risk of market abuse could be more pronounced for short selling not backed by securities lending, since they can be quicker and more consistent than covered sales. In fact, in the case of covered short selling, the hedging requirement could limit both the speed of the transaction (given the need to hedge itself) and its consistency (limited by the ability to borrow the securities)[15]. Furthermore, only sales not backed by securities lending involve the settlement risk, which by contrast is absent in covered short selling. A restriction on naked short selling would therefore operate in a selective manner, prohibiting precisely those short selling transactions which are potentially more risky.

This regulatory resolution however presents the same disadvantages as the restrictive option on all short selling, albeit to a more limited extent:

- a reduction on the price discovery efficiency;
- a reduction in the liquidity and a consequent increase in transaction costs;
- a reduction in operations on the spot market with the transfer of the same to the derivatives market;
- a reduction in operations at Italian level to the benefit of foreign markets and operators.

Also in this case, additional costs could be those relating to compliance (set-up costs) which the companies will have to incur in an initial phase for the purpose of consolidating their IT system in relation to the new regulations; these costs are probably higher with respect to the compliance costs associated with the previous option, since the observance of the restriction on making naked short selling requires the adoption of more complex control systems, capable of checking the presence of a loan corresponding to each short position held.

In conclusion, opportunity costs (foregone profits) are also present, albeit to a lower extent with respect to the previous case, along with the costs which Consob would have to incur for the performance of effective monitoring and enforcement activities.

CONSOB working hypothesis:

It is believed that the option in question presents, overall, lower costs with respect to the restrictive solution on all short selling, since the possibility of undergoing covered short selling transactions in

[15] The empiric data available does not permit us however to assess the validity of these theoretical hypotheses.

any event allows the market to benefit from the positive effects associated with short selling, in terms of price discovery efficiency and liquidity (albeit to a minor extent with respect to a regime where there are no restrictions).

With regard to the benefits deriving from the enforcement of this restriction, the matters already mentioned with reference to the previous option regarding their doubtful existence are valid.

In light of the benefits and costs potentially associated with this regulatory option, it is considered preferable not to proceed with its adoption.

3. Restriction on short selling in exceptional market situations

A further regulatory option which Consob intends to assess involves reserving itself the right to intervene with prohibitive measures on short selling in exceptional market situations. In fact, in exceptional market situations, such as that which occurred in the period following Lehman Brothers' declaration of bankruptcy, regulations other than the ordinary ones may become necessary, since the latter may be excessively lax.

This regulatory option has the merit of permitting the market to take advantage, under normal conditions, of the benefits of short selling, both in terms of price discovery efficiency and liquidity. On the other hand, it makes it possible reduce the risks of short selling precisely when they are most pronounced, or under market conditions of great turbulence and uncertainty.

Faced with these benefits, the potential costs associated with this option are linked to both the discretion which the Supervisory Authority has when identifying exceptional market situations where it is necessary to intervene, and to the costs (initial and on-going) which the market operators must incur so as to adapt to the changes in regulations which are not easy to forecast.

Since this regulatory option only applies under exceptional circumstances, and not on an on-going basis, it is clear that it is not an alternative to other restrictive regulatory options, with the exception of option 1 which petitions for, as mentioned, a permanent restriction on all short selling (both covered and naked).

CONSOB working hypothesis:

A review of the literature on the positive and negative effects of short selling has indicated that the benefits associated with this practice are relevant and empiricalally possible to demonstrate. By contrast, uncertainties remain with regard to the entity of the negative consequences associated with this practice. The conviction that the risks arising from short selling are significant under exceptional market conditions however seems to emerge: for example, the risk of market instability is without doubt greater in situations of particular tension, where short selling, generating panic and disorientating the operators, may contribute towards exacerbating the bearish trend of the market; the risk of market abuse also seems to be less pronounced in the presence of exceptional circumstances (for example: liquidity crisis).

Since the net benefits associated with this option appear to be strictly positive, it is considered appropriate that Consob reserve itself the power to intervene under exceptional market conditions.

4. Restriction on short selling of shares of companies subject to share capital increases

A further regulatory option which we intend to evaluate involves limiting the restriction on short selling to specific transactions, such as those involving share capital increases[16].

This regulatory option, like the previous one, has the merit of permitting the market to take advantage of the benefits of short selling, both in terms of price discovery efficiency and liquidity, under all the circumstances where the restriction does not apply. On the other hand, it makes it possible to reduce the risks associated with short selling in the presence of transactions particularly exposed to such risks. Analysis of the effects of short selling in fact highlighted that companies who go ahead with share capital increases may be particularly vulnerable to short selling, if such sales are used for purely manipulative purposes.

However, 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. In light of these observations, the restriction of just naked sales could be hypothesized, leaving the possibility of carrying out covered sales[17].

With regard to costs, the adoption of this option involves costs (initial and on-going) being incurred by the market operators.

CONSOB working hypothesis:

It is believed that the benefits associated with this option are greater than the related costs. This solution would in fact make it possible to reduce the risk of market abuse associated with the practice of short selling in circumstances where the same seems to be particularly significant, in any event permitting the market to benefit normally from the positive effects resulting from short selling.

Since the net benefits associated with this option appear to the strictly positive, it is considered appropriate to proceed with the adoption of a regulatory option restricting naked short selling in relation to specific transactions, such as share capital increases.

5. Tick rule

The tick rule is a device aimed at avoiding that short selling takes place in periods when the market is declining. The tick rule establishes that a security can be sold short only 1) at a price greater than the price at which the immediately previous sale took place (plus tick) or; 2) at the last sale price, if this is greater than the last different price at which the security was sold (zero plus tick)[18]. This rule

[16] It seems appropriate to exclude the share capital increase transactions which do not involve a monetary flow (for example share capital increases with the conferral of assets in kind or receivables), share capital increases serving remuneration plans for company representatives, employees or collaborators, and share capital increases underlying an issue of warrants or convertible bonds.

[17] This possibility would however be limited by the availability of the shares on the securities lending market, which will be lower the higher the conversion ratio envisaged by the share capital increase transaction is.

[18] Actually, it also exists an amended version of the uptick rule, recently subject to consultation by the SEC, which considers the best (highest) bid price at Italian level to be the reference value.

therefore avoids that short selling takes place when the prices of the securities are decreasing, for the purpose of exploiting negative market conditions and exacerbating the process of the reduction of the listed prices.

The implementation of a system where the tick rule is in force, is particularly complex and requires the intervention of several types of operator (see below). It is in fact necessary for the short selling orders to be indicated as such at the time they are issued (implementation of the so-called flagging system); in this way, it is possible to identify the sell order to be blocked when the market conditions do not permit their execution.

The enforcement of the tick rule may avoid that short selling is used to speed up a process involving the collapse of listed security prices already underway, creating greater confusion on the markets, and may contribute towards reducing cases of use of short selling for manipulative purposes.

On the other hand, the adoption of the tick rule leads to a reduction in short selling activities, with negative effects on the market's liquidity and on the price discovery efficiency, and involves the operators incurring, in this case as well, opportunity costs (foregone profits).
Furthermore, by adopting this regulatory option extremely high compliance costs (set-up costs) will be incurred for:

- the sellers, who must be able to identify the short selling;
- the brokers, who must change their IT systems so as to permit the correct functioning of the flagging system and the blocking of the orders which cannot be carried out according to the tick rule.

In addition to the initial compliance costs, it is necessary to consider those which are continual as well (on-going costs), which the market operators must incur so as to monitor and permit the correct functioning of the system.

Furthermore, a particularly significant cost associated with the application of the tick rule relates to the fact that operators have the possibility of dodging its application, operating on markets where the rule does not apply. The failed concentration of trading could therefore render the rule *de facto* ineffective.

In addition to the costs indicated so far, consideration must also be taken of the costs which Consob will have to incur for the performance of effective monitoring and enforcement activities.

CONSOB working hypothesis:

Previous analysis reveals that the main benefits associated with the adoption of the tick rule are linked to the possibility of reducing the risks of stability and market abuse associated with short selling. Nevertheless, considering the results of the pilot study carried out by the SEC in the period 2005-2007, following which the rule was abolished, doubts remain regarding the ability of the tick rule to achieve the objectives it was assigned[19].

[19] In the Usa the tick rule has been in force from 1938 to 2007. The rule was temporarily abolished by the SEC in the period 2005-2007, in order to carry out a pilot study with the aim of assessing the usefulness of the rule. The results of the pilot test cast doubts on the ability of the rule to reduce market manipulation and market volatility, while they showed that the tick rule contributed to reduce the market activity. Following the pilot test, the SEC decided to abolish the tick rule. However, despite this decision, the SEC recently submitted a series of measures for consultation which represent different variations of the tick rule.

With regard to costs, this regulatory solution seems to be characterized by particularly high implementation costs.
Considering that the potential benefits associated with this option were made futile in an unharmonized context and in light of the elevated costs associated with its implementation, at present it is considered preferable not to proceed with the adoption of this regulatory option.

3.1.2 Transparency regulatory options

1. Transparency options "in a strict sense"

a. Transparency on aggregate short selling

By means of this regulatory solution, the information relating to the entity of the aggregate short selling for each security is made public. So that this is possible, it is necessary to adopt a flagging system, as for the tick rule, so that each sell order corresponding to a short sale is marked as such. The broker, in turn, communicates the information to another operator (a party appointed for this purpose or said Supervisory Authority) which carries out the aggregation transactions and makes the information public.

The main benefit linked to this solution involves the reduction in the asymmetries between the informed and uninformed investors by publishing the data on the short selling transactions present on each security, the market can comprehend up to what point it is the short selling or the ordinary sale which determines the reduction in the prices of the security.

In the event the aggregation is carried out by the supervisory authority, the information on short selling could aid the identification of cases of market manipulation.

With regard to the benefits mentioned, the costs linked to the adoption of this regulatory option are several:

- empirical studies on the effects of the transparency show that the announcement of short selling on a security is interpreted as a negative signal by the market, which reacts by selling the security and emphasizing the reduction in its listed price. Nevertheless, the interpretation of short selling as a bearish signal is not always correct since the operators can sell short not only because they consider that the security is overvalued or because they have negative news, but also due to mere hedging purposes. Therefore, information on aggregate short selling present on a security may be misleading and lead to excessively negative market reactions, capable of altering the correct functioning of the price discovery process and causing sharp reductions in listed prices. Furthermore, the presence of such reactions by the market could encourage speculative activities or market abuse by the sellers, who could exploit the consequences to their advantage in terms of a reduction in the listed prices deriving from the market reactions to the announcements;
- the adoption of a flagging system of this type, not making it possible to monitor the closing stage of the bearish positions, could lead to an overestimation with regard to the alleged bearish pressure. This criticality could be reduced by the provision of a symmetrical flagging system for the purchases carried out to "cover" the exposed positions. On the other hand, this information could also be misleading since the operators could ensure, further on, the hedging of the exposed conditions also not operating on the markets, for example by means of derivative financial instruments;
- the adoption of this transparency regime requires considerable costs to be incurred, both by the market operators and by Consob:

- initial costs (set-up costs) for the implementation of the flagging system, by the sellers (who must identify the sales which are short), the brokers (costs for changing the IT systems) and by the party who will go ahead with the final aggregation of the data and its disclosure to the market;
- continual costs (on-going costs) for monitoring and updating the system;
- monitoring and enforcement costs for Consob;

- the information obtained by adopting a flagging system may be inaccurate, due to the complexity of the system and the difficulty in monitoring the correctness of the data provided. Therefore, when assessing this regulatory option, the costs linked to the imprecise nature of the information subject to disclosure are also considered;
- the operators could dodge the transparency regulation, operating on markets where there are no disclosure obligations;
- in general, it is necessary to carefully assess the effects which the provision of the transparency regime on aggregate short selling could have on the overall level of short-selling transactions carried out on the market. The transparency could in fact reduce the incentives of the operators to achieve these activities, with possible negative effects on the efficiency of the price discovery and arbitrage devices.

CONSOB working hypothesis:

The transparency regime on aggregate short selling involves significant compliance costs for the market operators and for Consob. In relation to these costs, the afore-mentioned regime has the benefit of providing information to the market on short selling. Nevertheless, due to the matters mentioned previously, the positive effects of a transparency regime on short selling are probably offset by possible excesses in the market reactions.

In light of the benefits and costs potentially associated with this regulatory option, it is considered preferable not to proceed with its adoption

b. Transparency on individual significant net short positions

An alternative transparency regime to the previous one is represented by the introduction of transparency obligations on net short positions[20] (or simply, unless indicated otherwise, short positions) which the individual operator holds on each security when they exceed specific thresholds which have been pre-established by the Supervisory Authority. In contrast to the previous option, the implementation of this solution does not require the adoption of a flagging system. Instead, it is necessary that the market operators change their IT systems for the purpose of constantly monitoring the entity of the net positions which they hold on each security and therefore observing the disclosure obligations on significant positions.

The Supervisory Authority establishes an initial disclosure threshold and any subsequent thresholds to the initial one, with disclosure obligations which become effective when the entity of the net short position returns to being inferior to the value thresholds previously exceeded.

The definition of the initial disclosure threshold is particularly relevant: a threshold which is too low could generate an excessive number of disclosures by the operators to the market, many of which lacking reporting value. By contrast, too high a threshold could select very little information, and neglect information which by contrast is important.

[20] The definition of net short position has been provided in section 2.1 of this position paper.

Also any subsequent discovery thresholds must be chosen so as to identify significant changes in the short position of a party.

The benefits associated with this option are several. Hypothesizing that the presence of short positions on a security is a sign of overvaluations and that the market acts consistently with this sign, then the sharing of the information on short positions with the entire market could improve the price discovery efficiency. In this connection, the main advantage associated with this option depends on the improved reporting ability of the new short position with respect to the simple short sale, given that the former does not includes the short positions held for hedging purposes. In this way, it is possible to provide the market with less misleading information, with minor risks of erroneous interpretation.

Transparency on significant short positions could also permit the Supervisory Authority to more easily identify any manipulative strategies aimed at unnaturally inducing bearish trends, by those who have significant net short positions on a security.

In light of these benefits, the option in questions presents significant costs:

- as already mentioned, a transparency regime may generate an excessive market reaction, which may manifest by means of mass sell orders on the security which is considered to be overvalued; in turn, this circumstance may encourage opportunistic conduct by sellers, who could gain advantage from the reduction in the listed prices consequent to the announcement. Furthermore, the communication of the names of the holders of short positions may produce another effect, the so-called “herding effect”. In short, if the name of the holder of the position corresponds to that of a significant party, who is believed to possess significant information, then the market could adopt generalized imitative conduct, selling the security and contributing towards a significant reduction in the listed prices;
- the communication of the names to the market discloses the strategies of those who hold short positions, exposing them to opportunistic conduct by competing operators, for example at the time the securities necessary for closing a short position must be acquired. In order to avoid similar consequences, the operators could choose to hold short positions solely for values less than the threshold, so as to avoid the disclosure obligations. In such a circumstance, the transparency would change into a restriction for all those transactions which make the transparency threshold binding, with significant costs both for the market, in terms of price discovery efficiency and liquidity, and for the operators themselves, in terms of foregone profits. The definition of adequate disclosure thresholds therefore appears crucial. The choice of an excessively low threshold could render the proposed scenario very likely, while the definition of an excessively high threshold could in fact reveal itself to be ineffective because too selective;
- also with respect to this regulatory option, the risk emerges that the information provided by the operators is not very accurate, both as a result of the difficulty for larger parties to calculate the overall net short position, and as a result of the difficulties of the Supervisory Authority to check the correctness of the information provided. It is however believed that this risk is lower than in the transparency regime on aggregate short selling. As a point of fact, the transparency regime in question does not require the information to be provided on an on-going basis, each time a sales order is issued, but only on exceeding a specific threshold. This should make the calculation of the short position more accurate;
- account is also taken of the compliance costs which the operators must incur both in an initial phase for setting up adequate IT systems capable of correctly calculating the net short position, and on an on-going basis, in order to observe the disclosure obligations over time.

It is however deemed that these costs are lower than the compliance costs associated with the transparency regime on aggregate short selling;

- there are the monitoring and enforcement costs which the same Consob must incur so as to ensure the correct application of the transparency rules.
- again in relation to this option, like the previous one, it is necessary to carefully assess the effects on the overall level of short-selling transactions achieved on the market. Transparency on the individual net positions could in fact make the reduction in the incentives for the operators to achieve these activities even more significant and, consequently, intensify the possible negative effects on the efficiency of the price discovery and arbitrage devices.

CONSOB working hypothesis:

The benefits expected from this regulatory option are linked to the sharing of the information on short positions with the market and to Consob's possibility of more easily identifying any cases of market abuse associated with the holding of short positions.

The regulatory option in question probably presents lower compliance costs, with respect to the transparency option for aggregate short selling, since it does not require the operators to set up a flagging system. In fact, it imposes the incurring of costs solely for holders of the short positions and not the brokers and the party with information aggregation functions as well.
Incremental costs, with respect to the transparency option for aggregate short selling, by contrast derive from the enforcement of a transparency regime for the names of the holders of short positions. In fact, if, as already observed, transparency can have undesired consequences, the disclosure of the names of holders of short positions may, on the one hand, increase the entity of these reactions, especially if the names of the holders of short positions correspond with significant operators, and, on the other hand, may in fact translate into a restriction on short selling for positions higher than the significance threshold.

In relation to this regulatory option, please see the CONSOB working hypothesis relating to all the transparency options considered (page 26).

2. Consob reporting option on individual significant net short positions

This regulatory proposal differs from the transparency option on the individual significant net short positions due to the different beneficiary of the disclosures, no longer the market but rather Consob.
Therefore, the previous comments relating to the expected costs and benefits are valid, with the following exceptions:

- as far as the benefits are concerned, that of sharing the information on the short positions with the market does not apply;
- with reference to the costs, both those relating to transparency in general (risk of excessive market reactions to the announcements, with possible opportunistic conduct by the operators aware of the market reactions), and the transparency costs regarding the names of the holders of the short positions (herding effect, costs linked to the reduction in short selling activities) do not apply.

CONSOB working hypothesis:

The reporting to the Authority of the individual net short positions greater than a certain threshold may permit Consob to more easily identify any manipulative strategies aimed at unnaturally inducing bearish trends, by those who have significant net short positions on a security.

Reporting to just the Supervisory Authority and not to the market as well however has the disadvantage of not permitting a wide disclosure of the information on the short positions, with potential negative consequences in terms of price discovery efficiency. Nevertheless, as already observed, as far as we are aware at present, the positive effects of a transparency regime on individual net short positions are probably lower than the negative effects.

In relation to this regulatory option, please see the CONSOB working hypothesis relating to all the transparency options considered (page 26).

3. Mixed reporting and transparency options "in a strict sense"

a. Reporting to Consob of individual significant net short positions and disclosure to the market of aggregate data

The reporting regime relating to significant net short positions could be supplemented by a transparency regime "in a strict sense", by means of the provision of disclosure obligations laid down by Consob to the market on aggregate information on the net short positions for each security.

Consob therefore, having received the data on the significant net short positions of each operator, would proceed with their aggregation, so as to disclose to the market the aggregate data, without revealing the names of those who hold significant short positions.

This option presents benefits and costs in line with the previous one, with certain exceptions:

- the disclosure to the market of the aggregate information on the significant net short positions could permit the operators to obtain useful information, with potential positive effects on the price discovery efficiency;
- as already indicated for the other transparency regimes "in a strict sense", the disclosure of the short positions could generate excessively negative market reactions;
- this option presents elevated costs for Consob, which takes on the form of the party recipient of the market disclosure obligations;
- the choice of the moment when Consob must make the aggregate information public is particularly significant. Information supplied late could lack any reporting value or even be misleading.

CONSOB working hypothesis:

In relation to this regulatory option, please see the CONSOB working hypothesis relating to all the transparency options considered (page 26).

b. Reporting to Consob and disclosure to the market of individual significant net short positions, with different forecast thresholds

The option in question identifies a two-level disclosure system: it envisages disclosure obligations on individual significant net short positions both with regard to Consob and the market, establishing however that these obligations arise on exceeding different thresholds.

In detail, an initial threshold (and any subsequent thresholds) lower for the reporting obligations to Consob is envisaged along with an initial threshold (and any subsequent thresholds) higher for the transparency obligations “in a strict sense”.

The provision of a relatively low threshold for the disclosure to Consob would permit the Supervisory Authority to more easily identify any manipulative strategies aimed at unnaturally inducing bearish trends, by those who have significant net short positions on a security. At the same time, by means of the definition of a high threshold for the transparency obligations, the market would only receive the information corresponding to **very significant** net short positions, probably endowed with greater reporting value. Furthermore, limiting the number of disclosures to the market, relating to those sent to the Supervisory Authority, it might be possible to contain the probable negative effects associated with a transparency regime and the disclosure to the market of the names of the holders of short positions.

CONSOB working hypothesis:

In relation to this regulatory option, please see the CONSOB working hypothesis relating to all the transparency options considered (page 26).

c. Transparency/Reporting on securities lending activities

An alternative approach to that of transparency or reporting on short selling or short positions involves the disclosure of the securities lending transactions or the outstanding positions relating to borrowed securities. The market or the Authority’s awareness of the securities lending transactions or the outstanding positions relating to borrowed securities could be used as a proxy for short selling activities.

Theoretically, a transparency or reporting regime on securities lending activities may closely follows the regulatory options analyzed in relation to short selling or short positions. In actual fact, it could therefore be possible to imagine the following regulatory options:

- Transparency of aggregate securities lending transactions;
- Transparency of individual significant positions relating to borrowed securities;
- Reporting to Consob of individual positions relating to borrowed securities;
- Reporting to Consob of individual positions relating to borrowed securities and disclosure to the market of aggregate data.

These options, however, albeit in their diversity, could emerge as not fully effective for the following reasons:

- 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.

CONSOB working hypothesis:

Information on securities lending activities represents an instrument, not always effective, for monitoring just covered short selling, and does not permit any assessment with regard to naked short selling.

In light of the benefits and costs potentially associated with this regulatory option, it is considered preferable not to proceed with its adoption.

* * *

Aside from the observations made in relation to each regulatory option, it was considered appropriate to present a CONSOB working hypothesis relating to all the transparency options considered.

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.

3.1.3 Regulatory options regarding settlement procedures

As indicated previously, certain costs ascribed to short selling, in particular sales not backed by securities lending (naked), essentially depend on settlement procedures. This is because these procedures can establish the last day by which the securities sold short must be delivered and, within this interval, the variables which influence the decision of the operators to deliver the securities sold.

In detail, the elements which stand out within the sphere of the settlement procedures are as follows:

1. the duration of the settlement cycle;
2. the existence and the nature of forced delivery procedures on the securities (so-called buy-in);

3. the existence and the amounts of penalties linked to the failed settlement of the transactions;
4. the amount of the margins requested by the central counterparty in relation to the transactions not settled subsequent to the intended settlement date; and lastly
5. the period running between the date of settlement envisaged contractually and the implementation of the buy-in.

With regard to transactions on shares carried out on regulated markets and in multilateral trading facilities (market transactions), the settlement interval contractually envisaged (**settlement cycle**) is, in most cases, three days (the only significant exceptions are the German markets where the settlement cycle is two days). In consideration of this fact, that is, since the settlement cycle is already sufficiently short, the elements indicated in points 2 to 5 merit relatively greater attention Further on, account will be given initially of points 2 and 5, relating to the buy-in procedures, and then to points 3 and 4, relating to the penalties and the margins applied to the fails.

The **buy-in** essentially involves the purchase on the market, by a third party and at the expense of the counterparty subject to fail, of securities forming the subject manner of transactions not settled as of the intended settlement date and the related delivery to the performing counterparty. It is of use to emphasize that the purchase of the securities is carried out at the expense of the counterparty subject to fail; this is true with reference to both the management costs of the procedure and, above all else, to any positive difference between the purchase price and the price originally agreed and paid by the performing counterparty.

In contrast, if a profit should be gained from the procedure – that is, the price originally agreed is higher than the purchase price and such that, considering the number of securities in question, it more than offsets the management costs – this might not be allocated to the counterparty subject to fail. If, effectively, any profit deriving from the buy-in procedure is not allocated to the counterparty subject to fail, market participants, including any parties who operate short, would have no interest in being subject to a buy-in procedure and therefore would be encouraged to meet their delivery obligations in time. In essence, in the event that the profit is not allocated to the counterparty subject to fail, the launch of the buy-in vis-à-vis a market participant, and the consequent forced close-out of its short positions, implies the possibility of incurring the losses but not the possibility of achieving the profits.

The first distinguishing elements, therefore, relate to the existence or otherwise of the buy-in procedure. In fact, lacking this procedure it is not possible to determine a latest deadline by which the securities sold must be delivered on the basis of normal market procedures. If a buy-in procedure exists, in the first instance it reveals the number of days subsequent to the intended settlement date, after which the purchase and the delivery to the performing counterparty becomes effective. If there is a large number of days, then the close-out of the positions before the launch of the buy-in will be possible. Furthermore, the nature of the buy-in procedure stands out. In this sphere, it is necessary to assess whether the buy-in procedure is a mandatory and standardized procedure or if by contrast it is left to the discretion of the performing counterparty, but above all else it is necessary to check whether any profit deriving from the buy-in procedure is allocated or otherwise to the counterparty subject to fail.

With regard to **points 3 and 4**, it is evident how the application of an essential level of penalties for failed settlement of the transactions, as well as the application of margins, by the central counterparty, with percentages essentially higher than those applied to the transactions pending settlement, is to say the least potentially able to encourage the reduction of the fails.

With respect to the points covered above, the Italian context presents:

a. a settlement cycle of three days (compliant with the situation prevailing in other countries);
b. a buy-in procedure handled on a mandatory and standardized basis by *Cassa di Compensazione e Garanzia* acting as the central counterparty; any profit deriving from the buy-in procedure is not allocated to the counterparty subject to fail;
c. a system penalizing the fails at day end (due to non-delivery of the securities) as part of the Express II settlement system run by *Monte Titoli*, on the basis of which a penalty of Euro 200 is applied only in the event that the settlement percentages are lower than the minimum efficiency levels. This system does not distinguish between market and non-market transactions;
d. segregation, and consequent separate margining, in the central counterparty system run by *Cassa di Compensazione e Garanzia*, of the positions in fail with respect to the positions pending settlement, involving application, nevertheless, of the same margining percentages;
e. the execution of the buy-in procedure on the eight day subsequent to the intended settlement date.

The above reveals that the regulatory options, principally, could involve:
1. a shortening the settlement cycle;
2. a change in the system for penalizing the fails at day end (due to non-delivery of the securities), which is based not only on the overall efficiency of the system, but also on the individual fails (with a sufficiently high level of penalties);
3. an essential increase in the margining percentages applied to the positions in fail registered in the central counterparty system, as from an intermediate day between the settlement date contractually envisaged and the execution day of the buy-in;
4. a reduction in the time period at the end of which the buy-in is carried out (buy-in interval).

Options 1 and 4 can be directly compared. Option 1 is the one which presumably presents minor benefits, at least with regard to short selling, and greater costs. In fact, with regard to the benefits, while the maximum reduction of the settlement cycle can be estimated, on the basis of the attempt made at the start of the decade on the US market, as two days, the reduction of the *buy-in* interval is potentially higher. With regard to costs, the reduction in the settlement cycle is decidedly more problematic than the reduction in the buy-in interval as a result, among other things:
- of the elevated investment costs necessary for avoiding that the reduction in the settlement cycle produces the sole effect of an exponential increase in the fails;
- of the lower number of parties involved in the buy-in procedure.

Furthermore, a reduction in the settlement cycle could not fail to be carried out on the basis of a harmonization at European level base.

Options 2 and 3 can also be compared directly, since both have the aim of making the fails more expensive. With regard to the benefits, the two options seem to be essentially equivalent. However, from the point of view of the costs, option 3 seems preferable since it more easily makes it possible to focus on market transactions.

CONSOB working hypothesis:

Despite **options 3 and 4** presenting benefits, it is not clear, in light of the current situation - which is considered satisfactory – and the related implementation costs, whether the net benefits associated with the same are positive.

3.2 Exemptions

In line with the matters envisaged for the measures recently adopted by Consob for the purpose of disciplining the phenomenon of short selling on a temporary basis, the restrictive or transparency measures on short selling proposed in this position paper do not apply to the activities carried out by the market makers, solely with reference to the activities carried out when performing the function. In detail, reference is made to both the activities carried out on regulated markets and in multi-lateral trading systems (activities to which Article 1.5 *quater* of the Finance Consolidation Law (TUF) makes reference when defining the figure of market maker), and to off-market operations.

Furthermore, the regulatory measures proposed do not apply to the specialists, as defined in the Regulations for markets organized and run by Borsa Italiana S.p.A., and to the intermediaries operating in execution of a liquidity contract (i.e. liquidity providers), provided that the activities are carried out when performing their functions on regulated markets.

The choice of exempting these categories of parties derives from the establishment of the relevance of the function performed by the same when providing the market with liquidity on an on-going basis, vital activities for the correct functioning of the markets.

Bibliography

Aitken, M.J., Frino, A., McCorry, M.S., Swan, P.L., (1998), Short Sales are Almost Instantaneously Bad News: Evidence from the Australian Stock Exchange, *Journal of Finance* 53(6).

Brent, A., Morse, D., Stice, E.K., (1990), Short Interest: Explanations and Test, *Journal of Financial and Quantitative Analysis* 25.

Boehmer, E., Jones, C.M., Zhang, X., (2008) Shackling Short Sellers: The 2008 Shorting Ban, *Working Paper*, disponibile su www2.gsb.columbia.edu/faculty/cjones/ShortingBan.pdf.

Boehmer, E., Wu, J., (2008), Short Selling and the Informational Efficiency of Prices, *mimeo*, disponibile su http://ssrn.com/abstract=972620.

Bris, A., Goetzmann, W. N., Zhu, N., (2007), Efficiency and the Bear: Short Sales and Markets Around the World, *Journal of Finance* 62 (3).

Bris, A, (2008b), Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order, disponibile su www.imd.ch/news/upload/Report.pdf.

Charoenrook e Daouk (2005), A Study of Market-Wide Short Selling Restrictions, *mimeo*, disponibile su http://ssrn.com/abstract=687562.

Clifton, M., Snape, M., (2008), The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange, report realizzato su incarico del London Stock Exchange.

Consob (2008), I Provvedimenti di Divieto di Vendite allo Scoperto: Prime Evidenze degli Effetti sul Mercato Azionario Italiano, *mimeo*.

Desai, H., Ramesh, K., Thiagarajan, S.R., Balachandran, B.V., (2002), An Investigation of the Informational Role of Short Interest in the Nasdaq Market, *Journal of Finance* 57(5).

Diamond, D.W., Verrecchia, R.E., (1987), Constraints on Short Selling and Asset Price Adjustment to Private Information, *Journal of Financial Economics*, 18(2).

Epstein, G., (1995), Short Can Be Sweet, Barron's, October 2.

ESME, (2009), Position on Short Selling, March, disponibile su http://ec.europa.eu/internal_market/securities/docs/esme/report_20090319_en.pdf.

Financial Services Authority, (2009), Short Selling, *Discussion Paper* 09/1, February, disponibile su http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf.

Gintschel, A., (2001), Short Interest on Nasdaq, disponibile su http://www.fmpm.org/docs/5th/Gintschel.pdf.

Henry, T.R., Koski, J.L., (2008), Short-selling Around Seasoned Equity Offerings, *mimeo*, disponibile su http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972076.

Iosco, (2003), Report on Transparency of Short Selling, Technical Committee of International Organization of Securities Commissions, June.

Iosco, (2009), Regulation of Short Selling, *Consultation Report*, Technical Committee of International Organization of Securities Commissions, March, disponibile su http://www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf.

Karpoff, J.M., Lou, X., (2008), Do Short Sellers Detect Overpriced Firms? Evidence from SEC Enforcement Actions, *mimeo*.

Marsh, I.W., Niemer, N., (2008), The Impact of Short Sales Restrictions, *mimeo*.

Miller, E., (1977), Risk, Uncertainty, and Divergence of Opinion, *Journal of Finance* 32.

Saffi, P.A.C., Sigurdsson, K., (2008), Price Efficiency and Short Selling, *mimeo*, disponibile su http://ssrn.com/abstract=1264939.

Safieddine, A., Wilhelm, W., (1996), An Empirical Investigation of Short-selling Activity prior to Seasoned Equity Offerings, *Journal of Finance* 51(2).

Senchack, A.J., Starks, L.T., (1993), Short-sale Restrictions and Market Reaction to Short-interest Announcements, *Journal of Financial and Quantitative Analysis*, vol. 28 (2).

Shkilko, A., Van Ness B., Van Ness R. (2008), Price-destabilizing Short Selling, *mimeo*, disponibile su http://ssrn.com/abstract=971210.

Attachment

Questionnaire

1. The preliminary choices

Q1) Do you consider it appropriate for specific regulatory measures to be introduced on short selling?

Q2) If yes, do you agree that the potential areas of intervention are:
a) the introduction of restrictions on the achievement of short selling transactions (partial or total);
b) the provision of transparency obligations vis-à-vis the market (which can be modulated variably) and/or reporting obligations vis-à-vis the Supervisory Authority;
c) regulatory options regarding settlement procedures, which aim at disciplining the fails associated with naked short selling?

Q3) What other areas of intervention should eventually be considered?

2. Analysis of the regulatory options

a) the introduction of restrictions on the achievement of short selling transactions (partial or total)

Q4) Do you consider it appropriate to envisage rules which permanently prohibit all short selling, both naked and covered?

Q5) If you answered no to Q4), do you consider it appropriate to envisage rules which permanently prohibit just naked short selling (not backed by securities lending)?

Q6) If you answered no to Q4), do you consider it appropriate to introduce forms of restriction on short selling in exceptional market situations?

Q7) If you answered no to Q5), do you consider it appropriate to enforce a permanent restriction on naked short selling of shares of companies subject to share capital increases?

Q8) If you answered no to Q4), do you consider it appropriate to adopt the tick rule?

Q9) Which other forms of restriction should eventually be considered?

b) the provision of transparency and/or reporting obligations

Q10) Do you consider it appropriate to envisage transparency obligations vis-à-vis the market with regard to short selling?

Q11) If you answered yes to Q10), do you consider it preferable that the transparency concerns either:

- *aggregate short selling for each security, by means of a flagging system of the trading orders;*

- *individual net short positions over specific thresholds? In this case, indicate what the threshold system should be (initial threshold and any other subsequent thresholds).*

Q12) If you answered no to Q10), do you consider it appropriate to envisage reporting obligations vis-à-vis the Supervisory Authority for individual net positions over specific thresholds? If the answer is yes, specify what the threshold system should be (initial threshold and any other subsequent thresholds).

Q13) If you answered yes to Q12), do you consider that the data should be aggregated and disclosed to the public by the Supervisory Authority? If the answer is yes, specify how frequently.

Q14) If you answered yes to Q12), do you consider it appropriate to envisage reporting obligations vis-à-vis the Supervisory Authority and transparency obligations vis-à-vis the market on individual significant net short positions, with provision of a minor disclosure threshold for the reporting obligations? If the answer is yes, specify what the threshold system should be (initial threshold and any other subsequent thresholds).

Q15) If you answered no to Q10) and Q12), do you consider it appropriate to envisage transparency and/or reporting obligations of securities lending activities?

Q16) What other forms of transparency or reporting should eventually be considered?

Q17) In the event of groups, which party within the group do you consider should be the recipient of the disclosure obligations?

c) regulatory options concerning procedures for the settlement of securities transactions

Q18) Do you consider it appropriate to envisage measures regarding settlement procedures?

Q19) If you answered yes to Q18), do you consider it appropriate to reduce the buy-in interval? If the answer is yes, also indicate the preferred time period.

Q20) If you answered yes to Q18), do you consider it appropriate to make a substantial increase to the margining percentages applied to the positions in fail registered in the central counterparty system?

Q21) What other options regarding settlement procedures should eventually be considered?

3. Quantification of the costs/benefits

a) the introduction of restrictions on the achievement of short selling transactions (partial or total)

Q22) What, in your opinion, are the costs and benefits associated with the option which involves the restriction on all short selling? If possible, provide a quantitative estimate, with particular reference to any compliance costs.

Q23) What, in your opinion, are the costs and benefits associated with the option which involves the restriction on naked short selling? If possible, provide a quantitative estimate, with particular reference to any compliance costs.

Q24) What, in your opinion, is the entity of the costs associated with the implementation of a flagging system? If possible, provide a quantitative estimate.

b) the provision of transparency and/or reporting obligations

Q25) What, in your opinion, are the costs and benefits associated with the transparency regulatory option on aggregate short selling for each security? If possible, provide a quantitative estimate.

Q26) What, in your opinion, are the costs and benefits associated with the transparency regulatory option on individual significant net short positions? If possible, provide a quantitative estimate.

Q27) What, in your opinion, are the costs and benefits associated with the reporting regulatory option? If possible, provide a quantitative estimate.

4. Exemptions

Q28) Do you agree with the proposal to envisage exemptions for certain types of operators?

Q29) If you answered yes to Q28), do you consider it appropriate to envisage further exemptions in addition to those proposed?