Commentary: European Derivatives and Short Sales Rules Revisited

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All securities regulation is a variation of two themes – prohibition and disclosure. In the United States, our federal securities laws are heavily tilted in favor of disclosure, or transparency, as the preferred method of regulating the purchase and sale of securities. State securities laws, in contrast, traditionally have favored "merit review," which is a form of prohibition. Under merit review, if the securities to be issued are determined by a regulator to be without "merit," they may not be issued, purchased or sold.

But it is a mistake to think that these are mutually exclusive methods of regulation. In spite of policies favoring disclosure, many federal securities regulations amount to prohibitions. For example, the short sale rules adopted by the SEC regulate through prohibition. After a circuit breaker is tripped, traders may not sell short on a down bid. Short sales may not be made unless an investor has pre-borrowed a security.

Prohibition is generally regarded as a more severe form of regulation. Industry advocates, preferring disclosure to prohibition, frequently quote the famous aphorism by Justice Brandeis: "Sunlight is the best of disinfectants." After all, disclosure requirements do not prohibit the activity, although as a practical matter, they may render it impossible to perform. Buyers are extremely reluctant to go through with a transaction when informed that what they are buying is worthless.

On September 15, 2010, the European Commission released companion legislation for the regulation of securities derivatives and short sales. The proposals contain very few surprises – the Committee of European Securities Regulators (CESR) has been conducting consultations on these regulatory proposals for many months. Conceptually, the proposed legislation illustrates the tensions that exist between the two tools available for the regulation of securities – disclosure and prohibition.

For short sales of publicly traded shares, the European Commission would regulate primarily through disclosure. At certain position thresholds, to be established by the newly organized European Securities and Markets Authority (ESMA), a short seller must notify a "relevant competent authority," which will usually be the short seller's home state securities regulator. For short positions greater than .5% of the outstanding shares, and at .1% thresholds thereafter, the short seller must disclose

the position publicly. Significant short positions in sovereign debt or credit default swaps of sovereign debt must be disclosed to regulators, but not publicly. These disclosure requirements would also apply to "synthetic" short positions acquired through derivatives other than credit default swaps.

Probably at the nudging of US regulators, European short sellers generally will face a delivery for settlement requirement that will force them to borrow securities in most cases. Unlike the rule in the United States, however, market makers would enjoy an exemption from the borrowing and delivery requirements.

The new rules would restrict the ability of Member States to impose their own short selling restrictions, such as the ones Germany imposed a few months ago on European sovereign debt. Member States would have the power to impose emergency measures, which could involve additional disclosure, short sale prohibitions on particular instruments or limitations on the size of short positions. To impose these emergency measures, the Member State would have to determine that there is a serious threat to financial stability or market confidence and the measures are necessary to address that threat. The Member State would also be required to provide 24 hours notice to ESMA. In turn, ESMA would be required to issue an opinion within 24 hours stating whether or not it agrees with the Member State that the emergency measures are necessary to avoid a financial crisis. ESMA will also have the power to impose its own measures on a European-wide basis that would override actions taken by any Member State.

The European Commission's proposal nowhere contemplates any sort of uptick or modified uptick prohibitions for the regulation of short sales, such as those imposed on U.S. equity markets.

For all derivatives, the European Commission would require trade and position reports to regulators. In addition, the European Commission would encourage more standardization of derivatives contracts with a view to requiring trades to be cleared through central counterparties, much the way standardized options are traded in the United States, but would not prohibit the trading of non-standard OTC derivatives altogether.

In the United States, it is a popular conceit to depict European regulators as more severe and less reliant on markets than regulators of the American "free markets." Yet in the regulation of short sales, the Europeans seem content to rely mainly on disclosure, where the United States has chosen to rely on rules of prohibition. Short sale prohibitions, under the European Commission's latest proposals, would only occur in true emergency situations, and the rules would erect significant barriers to their implementation by regulators.

In its derivative regulatory proposals, the European Commission describes a continuum of regulation, from relying on industry initiatives to relatively severe prohibitions. I think this is the right way to think about regulation. The decision to allow the industry to regulate itself, relying on "best practices" and social constraints to limit human cupidity, is best conceived as a loose form of regulation, rather than as "no regulation."

In its releases, the European Commission has given a lot of consideration to the possibility of relying on industry initiatives, which are considered "light touch" methods of regulating the purchase and sale of derivatives, eventually concluding that these methods will be insufficient to protect the public and the European economy. However, the Commission has rejected requiring all derivatives to be traded on exchanges and cleared through central counterparties – effectively prohibiting OTC derivatives – as unnecessarily draconian. Instead, the Commission favors a mix of disclosure and prohibitions, relying predominantly on disclosure.

The short sales and derivatives releases also demonstrate that the European Commission is keeping a very close eye on U.S. regulation. The Commission is unwilling to impose on European markets regulation that is more prohibitive than what is being instituted in the United States, and in most cases is content with a somewhat lighter touch.

The European Commission's short sales and derivatives proposals also continue the trend towards regulatory convergence. The European Commission is moving towards a very sophisticated and competitive regulatory scheme, keeping a sharp eye on U.S. regulatory developments. Inevitably, greater convergence will constrain the severity of the regulatory tools available to the SEC and other U.S. regulators.

The fact is that in recent years, there has not been much enthusiasm in the United States for imposing financial services regulations that Europe is not willing to match. The exceptions, such as the short sale market price test prohibitions, which were a watered-down product of political expediency, prove the rule.

It seems odd that American zeal for regulation would be curbed by European free marketeers. But, this is a two-edged sword. With regulators on both sides of the Atlantic sharing notes, it will be increasingly difficult to argue that regulation causes a loss of national competitiveness or that a move toward less severe forms of regulation will improve the ability of U.S. firms to compete on a global basis.

I guess this means that U.S. investment banks will have to compete with European firms by providing a better product at lower cost.