Commentary: The Next Chapter in European Short-Sale Regulation

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European market regulators generally have taken a fairly benign view towards short selling. Nothing like the uptick rule has been imposed on any major European market center. In general, European market participants are not required to borrow stock, or otherwise commit to deliver it, when placing an order to short stock.

From time to time, however, during periods of market stress, European regulators react in draconian fashion by prohibiting short sales in certain financial instruments altogether. When the financial crisis was tanking the stocks of banks and other financial institutions in 2008, the Financial Services Administration (FSA) in London banned short selling in these stocks. The U.S. Securities and Exchange Commission responded in similar fashion, with some regret. But, while the U.S. prohibition lasted for a couple of weeks, London regulators kept the ban in place for months. In May of this year, German regulators imposed short sale bans on euro-denominated government bonds in reaction to the run on European sovereign debt precipitated by the crisis in Greece.

The London and German bans on short sales produced shock waves throughout the European Union and resulted in calls for pan-European regulation. In the wake of the London prohibition, the Committee of European Securities Regulators (CESR), as reported in this column, produced a "call for evidence" soliciting views on the need for short sale regulation. This led to a proposal to adopt certain disclosure requirements for short sale positions, which mimicked the rules instituted by the FSA after it relaxed its ban on short sales of financial institution stocks. However, CESR is only an advisory body, soon to be replaced with ESMA, the European Securities and Markets Authority, which is a first pan-European attempt to establish something like the SEC in Europe.

On June 14, 2010, on the heels of the German short sale ban, the European Commission, the source of all pan-European legislation, produced a "Public Consultation on Short Selling," which provided only about one month for public comment. Proposed legislation is expected by the end of summer.

Why the rush? In "Frequently Asked Questions," the Commission cited "political considerations."

The European Union is first and foremost an economic union. Its member states have agreed to surrender their authority over those economic issues that the Union preempts through European-wide legislation. In that way, the European member states have sought to preserve their sovereignty over most matters, while surrendering their economic interests to the greater good. The European Union is founded on the fear that without presenting a united economic front, Europe would fall behind the United States.

As the history of nation building goes, the European Union is somewhat unique. In the past, national groups were formed primarily for defense against stronger, predatory neighbors. So, while the United States has as one of its goals "to promote the general welfare," this principle of union is preceded by the need to "insure domestic tranquility" and "provide for the common defense." Neither of these latter goals is part of the EU's brief.

That is why the short selling prohibitions instituted by London, and especially the more recent bans by Germany, provoked such controversy. These actions by individual member states contradict the principle of a single market on which the European Union is based.

The Commission's short selling consultation seeks advice from the public about CESR's disclosure recommendations. Should disclosure just cover equities, as proposed by CESR, or extend to cover all financial instruments, or perhaps something more than equities, but less than all financial instruments? The disclosure could, for example, apply to sovereign and corporate debt, as well as the much-hated credit default swaps.

The consultation also seeks advice on whether European member states should be permitted to institute short sale prohibitions on an emergency basis. No thought is given to allowing any member state simply to go its own way on short sales. The Commission's consultation suggests that a member state should be permitted to impose an emergency ban only if ESMA approves the ban on short notice.

The Commission also asks whether uncovered short sales should be prohibited or limited. Since a ban on naked short sales has never before been proposed, even in Germany, this proposal would seem to be a nod in the direction of U.S. regulation.

The most interesting question raised by the consultation for U.S. traders is the extent to which the proposed disclosure and other requirements should extend beyond the borders of the European Union. The fact is that most stocks traded in U.S. markets also trade in European markets. Accordingly, an institution that would prefer not to borrow stock to establish a short position can place an order in London or Frankfurt. The proposed European ban on naked short selling would therefore serve to prevent this circumvention of the U.S. borrow rules.

As a practical matter, clearing costs in Europe effectively prohibit most short sellers, and certainly high-frequency types, from circumventing the U.S. "modified uptick rule" by trading in European markets. But, European regulators are working on bringing clearing costs down. If they are successful, the modified uptick rule could easily be avoided by trading in Europe, at least by institutional investors.

Similarly, short sale regulation of credit default swaps and European bonds could be defeated simply by trading these instruments, or their synthetic equivalents, in the United States. Market participants in the swaps and bond markets are almost entirely composed of institutional investors.

The checkered history of European market regulation demonstrates the difficulty securing agreement on economic issues among sovereign nations, even when those powers have agreed to surrender their economic prerogatives to serve some greater common good. But, neither the United States nor the European Union has agreed to surrender their rights of economic determination. This means that convergent regulation of the sort necessary to establish a common set of short sale rules must survive difficult negotiations among regulators rooted in different cultures.

So far, G-20 efforts to secure agreements on common rules for financial institutions have enjoyed limited success. But without such an agreement on short sales, as well as a plethora of other issues, market rules are readily avoided. If the history of national formation is any guide, European and U.S. regulators will eventually reach such agreements. History also tells us that this blessed result is rarely accomplished peacefully. Stay tuned.

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