As part of our advocacy on short sale regulations, MFA's Michael Pedroni and AIMA's Jiří Król sent the below note to European Securities and Markets Authority Chair Steven Maijoor and Executive Director Verena Ross.

March 19, 2020

Dear Steven and Verena,

MFA and AIMA have been following the implementation of several short selling bans throughout the EU, and we want to email you before any additional measures are announced in order to set out our concerns about both the impact and structure of these restrictions. Verena and Fabrizio have kindly agreed to speak to us later today. But given press reports that Markus Ferber has sent you a letter requesting an EU-wide ban, and given how quickly the national bans are moving, we want to share our ideas as soon as possible. Our goal is to help ESMA and the NCAs to avoid the chaotic experiences with disparate announcements over the last several days.

The recent turmoil in the markets has been distressing, not to mention the growing global health crisis. However, with respect to regulatory responses, **we believe short selling bans do not dampen downward price movements and volatility, they exacerbate them**. There is a growing body of evidence to that effect, and, we fear, that further extending short selling bans will harm EU capital markets at a point where they can ill afford further disruption.

Studies conducted since 2008 show that the **median bid-ask spread for securities subject to short selling restrictions were 2.27 times larger than their pre-restriction values, showing a significant deterioration of liquidity**. This spread widening functions as a tax on all investors trading the affected securities. In 2008, Italy saw the worst impact on liquidity, with Denmark, Australia, and Norway close behind. With respect to risk aversion, in 2011 when several countries implemented short selling bans in response to the euro crisis, investors' risk aversion increased significantly immediately following the announcements. In addition, throughout the restriction period median volatility skews, which can be used as a metric for risk aversion, rose much more for restricted stocks than for unrestricted stocks. Short selling restrictions have also been shown to slow price discovery as they limit the ability of investors to react to new information.

In periods of market turmoil, the negative signaling associated with restricting short selling, combined with the deterioration of liquidity and price discovery, ultimately increases uncertainty and leaves the system worse off. It is also inconsistent with the objectives of the capital markets union.

Here are a few reasons our members cite to explain why short selling bans make things worse:

1. **Taking liquidity away on the long side:** Long/short and market neutral strategies cannot simply turn off the short leg of their trades and continue on a 'long only' basis. To take away the ability

to adjust their short positions as they dynamically react to price movements, means taking away the ability for them to enter long positions as well – thus reducing liquidity.

2. **Taking away stabilization of short covering trades:** Short positions are eventually covered by managers purchasing back stock once the price of a security has fallen. In such situations, they provide an important counterweight to the tide of selling, stabilizing prices and reducing volatility.
3. **Fueling panic around affected stocks and negative spillovers in adjacent market:** Bans will affect the functioning of markets through contagion as market participants, in anticipation of further restrictions, engage in larger-than-normal reduction of positions.

Having said that, if NCAs in Europe nonetheless proceed with temporary bans, <u>we would urge ESMA to include clear guidance on several important issues that have created substantial uncertainty over the last few days, three of which we would like to single out at the moment</u>:

1) **Rolling Positions** – We believe it is important to permit rolling of existing net short derivatives positions, where there is no creation of a new net short exposure, but rather maintenance of the pre-expiry position (typically this involves index futures). If firms are unable to roll existing derivatives positions it could lead to selling as firms unwind long positions that can't be hedged effectively. As you may know, the CNMV has only today clarified, at our request, that: "Rolling of existing net short derivatives positions is allowed as the transactions covered by the ban are only those that imply the building or the increase of a net short position. Entities do not have to unwind existing positions." The AMF has likewise today indicated that it shares this view and intends to update its FAQs to this effect. We recommend that ESMA urge NCAs to use standardized template language to clarify this for investors before the markets open.

2) **Convertible Bonds** – Investors in convertible bonds often use an investment strategy in which they are long on the convertible bonds of a company and short its shares in order to hedge their risk. Importantly, these firms are not net short. If firms were not able to hedge their risk through short sales, they would need to sell the convertible bonds. The CNMV in its guidance helpfully provided an exclusion for this type of hedging strategy, and we recommend that ESMA urge the other NCAs to provide the same exclusion. Specifically, the template language should state that: "The creation of, or increase in, net short positions when the investor who acquires a convertible bond has a delta-neutral position between the equity component of the convertible bond and the short position taken to cover that component."

3) **Application to Indices** – The existing short selling bans provide a threshold before shorting an index is prohibited, which is important to avoid banning the shorting of an index even if it has only one banned share. The initial French ban did not specify a threshold, but has since included the following guidance: "The creation or increase of net short positions through indexed financial instruments or baskets of shares are excluded from the ban when the shares subject to the decision represent less than 50% of the composition of the index or basket." We recommend that language become standard.

We are in the process of collecting further feedback and are already aware of additional important issues members grapple with when faced with short selling bans and will communicate them to you as soon as possible.

Finally, we would urge no lowering of the 0.5% public reporting threshold. As you know, after the implementation of the SSR, ESMA studied the effects of requiring investors to disclosure certain short positions. ESMA's findings showed that disclosure thresholds create risk of pricing inefficiencies as investors cluster right below the threshold out of reluctance to expose their strategy. In the April 2018 TRV, **ESMA also found that "investors react to public disclosure by increasing the size of their position, thereby reinforcing herd behavior."**

ESMA's decision on Monday to temporarily change the net short reporting obligation for shares by reducing the reporting threshold came as a surprise to the market. Changes to reporting requirements are operationally very difficult for firms to enact in such short order, and regulatory surprises like these can often be debilitating to an already vulnerable market.

As always, please treat MFA and AIMA as a resource as you are working through these issues and do not hesitate to reach out if we can be useful to you or your staff.

Best wishes,

Michael and Jiří

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