Position of Deutsche Börse Group
on
„Draft Regulation on Short Selling and CDS“

During the financial crisis, exchanges with their transparent and regulated markets have proven to be resilient and have had a stabilizing effect on the financial markets. Established and proven security mechanisms exist in a transparent on-exchange environment. Settlement takes place within two or three days and there are buy-in mechanisms and penalties by central counterparties in place to ensure high settlement discipline, both for long and short trades. The OTC market does not follow similar standards yet.

The established German act on short selling[1] has proven to be well suited. It provides transparency for net short positions following the CESR recommendations[2]. Covered short selling is allowed while uncovered short selling is allowed intraday, but banned on an overnight basis. Market makers and similar liquidity providers are exempt from the ban.

Deutsche Börse Group welcomes the current draft regulation on short selling by the European Commission.

We highly appreciate the consequent implementation of CESR’s proposals for a European transparency system for net short positions. Moreover, we believe that the requirement of the marking of orders on trading venues is not an adequate measure to improve transparency. Such order marking leads to high implementation costs for users, infrastructure providers and trading venues, which will ultimately be borne by the end investors, while the additional benefits are questionable. Order marking requires the implementation of highly sophisticated real-time systems that constantly monitor long/short positions. These systems have not been necessary in today’s landscape due to well-established and functioning procedures and practices throughout the whole value chain – from order entry checks to order lifecycle monitoring in an integrated execution management system to real-time risk management at Eurex Clearing. A reporting of marked short orders only by trade venues on an aggregated level misses the point of preventing market abuse and manipulative behavior. Moreover, this reporting only includes orders on trading venues – the current draft does not envisage OTC orders at all. In contrast, a reporting obligation of net short positions provides better transparency on exposure (especially due to the fact that OTC transactions are included) – both in terms of reporting quality (a trader’s actual position) and quantity (avoids inflated reporting of orders on a gross basis without considering the hedge) .

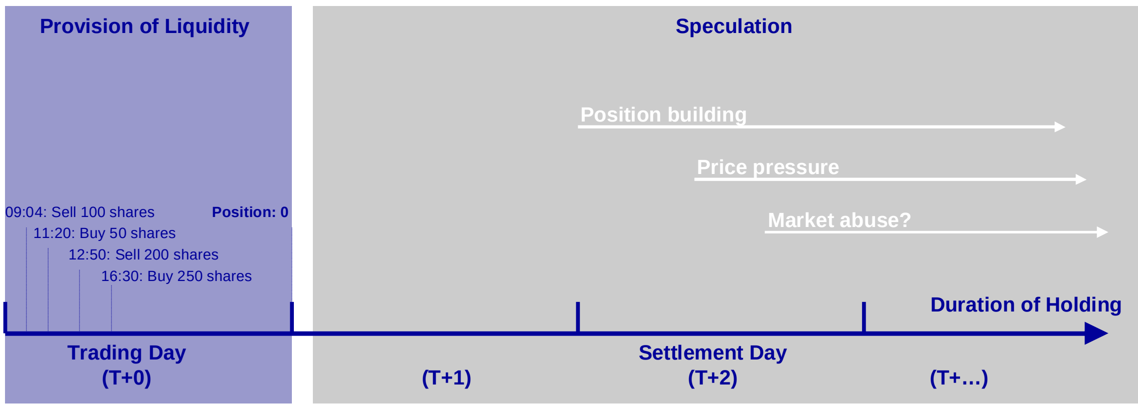
[1] On 27 July 2010, the Act on the Prevention of Improper Securities and Derivatives Transactions (Gesetz zur Vorbeugung gegen missbräuchliche Wertpapier- und Derivategeschäfte) entered into force.

[2] CESR Report “Model for a Pan-European Short Selling Disclosure Regime”, March 2010.

Uncovered short selling is an established market practice. It ensures flexibility for liquidity providers which enable them in turn to provide shares for investors, and buy them back later. In most cases, these shares are bought back within the same trading day. Fulfilling this function, uncovered short selling supports liquidity and decreases trading costs for investors. In turn, issuing companies benefit as their cost of capital decreases. Uncovered short selling is therefore valuable for the functioning of an efficient market. A ban needs substantiated reasons, which should be able to compensate for the loss of the respective benefits.

One reason to justify a potential ban might be the use of uncovered short selling as an instrument for abusive behavior and market manipulation. However, dedicated provisions and regulations already exist to address these abusive practices. Therefore, a potential ban should focus on areas where manipulative behavior can effectively be addressed, without adversely affecting the benefits of uncovered short sales on market efficiency. These areas include the segment of OTC trading and, possibly, uncovered short positions that extend across several trading days.

However, selling equities or sovereign debt instruments and buying them back later that day is not a problematic activity, but would be defined as short selling and therefore fall within the scope of the law. This kind of intraday trading fails to target the legislator’s objective to prevent market abuse and speculation. In contrast; it is extremely important in order to organize liquid and transparent markets and thus contributes to an efficient refinancing of the real sector. Following the objective of the legislator, it has to be taken into account that potential speculators who aim at putting pressure on share prices have to hold their positions over a couple of days if their strategy is to be successful. The figure below illustrates the difference between economically reasonable liquidity provision in the intraday area and possibly speculative uncovered short selling.



It should be strongly emphasized that uncovered short selling has to be separated from settlement failures. In other words: uncovered short selling does not automatically cause settlement failures, respectively settlement failures can occur without the usage of uncovered short selling, e.g. from a delay in the re-alignment delivery between different settlement locations, i.e. the settlement location where the seller’s custodian holds the securities and the settlement location entitled by a specific market place. In case of exchanges, in most markets a functioning buy in procedure is already in place. The proposed four days after a trade takes place is a very short time period for a buy-in: especially concerning cross-border transactions. Moreover, a differentiation between market maker and non-market maker is not feasible because outstanding obligations between the clearing member and the clearing house are representing the total of all trades cleared via this clearing member from several trading members and under several capacities.

A cash compensation, independent from the fact that it is well-defined in the rules & regulations of a clearing house, should only take place in case, the delivery of the securities owed is not possible and several buy-ins have failed as it does not result in what the buyer wants (the securities).

In emergency situations it may be necessary to prohibit short selling activities for a limited time. ESMA should be in the position to ban short selling in case predefined conditions are met. We suggest empowering ESMA to avoid national differences and regulatory arbitrage in respect to differing national short selling bans. Moreover, we question the named ‘objective criteria’ for temporary restriction of short selling (e.g. the fall in value of more than 10%). Such an approach is inflexible. Such a ‘one-size-fits-all’ approach might be feasible for liquid equities but not for less liquid equities such as penny stocks. Therefore, we suggest not detailing the conditions for temporarily restrictions before a detailed assessment by ESMA.

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