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Short selling during and after the financial crisis:
regulatory initiatives in Belgium, the United Kingdom and Europe

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Preface and acknowledgments

This master’s thesis is the capstone of my law degree at Ghent University. Since, throughout my legal education, I have been drawn to the regulation of financial markets, the regulation of short selling during and after the financial crisis seemed like a perfect subject for my thesis.

Given the controversy around short selling and the recent European regulatory initiatives, I believe this subject to be highly relevant in modern times. Moreover, it constitutes an illustration of how a financial crisis affects regulation and how, subsequently, regulatory changes affect the economy.

I wish to use this opportunity to express my gratitude to several people, without whom I would not have been able to write this thesis. First and foremost, I want to thank my supervisor, Professor Ignace Claeys, for providing me with invaluable advice and much needed guidance. Furthermore, I am grateful to my parents, who have given me more support than I could ever have asked for. Finally, I extend my gratitude to Sarah, my brother and my friends for their encouragement.
Introduction

The fall of American investment bank Lehman Brothers in September 2008 initiated a wave of temporary anti-short selling measures all over the world.¹ When explaining to Congress what caused Lehman Brothers to go bankrupt, its former CEO, Richard S. Fuld, pinned the blame (partially) on “naked short attacks”, stating: “as the crisis in confidence spread throughout the capital markets, naked short sellers targeted financial institutions and spread [rumours] and false information. The impact of this market manipulation became self-fulfilling [...]”.² By imposing restrictions on short selling, regulators across the world seemed to give the signal that short selling did in fact contribute to the financial crisis. In 2012, the temporary measures against short selling imposed during the financial crisis evolved into a European-wide regulation of short selling. In this thesis, we will analyse the regulation of short selling in Belgium, the UK and the European Union in the light of these studies.

This thesis consists of four titles. Under the first title of this thesis we provide an introduction to short selling in order to make the reader acquainted with what short selling exactly is and who engages in it. We begin this thesis by providing a definition of short selling and analysing how different regulators often provide a different meaning to the term “short selling”. In order to do so, we must first explain the difference between naked and covered short selling. Finally, an overview is given of the different types of short sellers and the different motives they have for short selling.

Under the second title of this thesis, we will address the possible reasons for the regulation of short selling. Therefore, a more in-depth analysis of the non-legal aspects of short selling is provided. First, we will analyse and summarise the many economic studies available on the effects of short selling on the economy. We believe a thorough understanding of the impact of short selling on the economy is indispensable for a better understanding of regulators’ motives for restricting short selling. Both the benefits and downsides of short selling for the economy will be addressed. Besides analysing the effects of short selling on the economy, we will also assess the impact of any restrictions on short selling. Secondly, we will study the morality of short selling. We do so because we consider the ethical or unethical nature of a certain activity

¹ See Annex for an overview of the measures taken across the world.
an important aspect to be taken into account when creating regulation with regard to this activity. Finally, we analyse whether short selling amounts to speculation, as short sellers are often depicted as speculators.\(^3\) If this is true, the restriction on short selling may be justified as part of the restriction on speculation.

The third part of this thesis will contain a thorough analysis of the measures against short selling imposed during the financial crisis in Belgium and in the UK. In both countries, two types of measures were taken: a prohibition of short selling and a disclosure requirement for short sellers. We will discuss the content of these measures and the legal framework in which they were introduced. With regard to the prohibition of short selling, the approaches of the Belgian and the UK regulators were widely different. Under this third title, we will compare the content as well as the effects on the economy of both approaches. In order to do the latter, we will summarise the results of empirical research on the impact of short selling restrictions during the financial crisis. Furthermore, we observed a difference in the duration of the measures against short selling. We will conclude the third part of this thesis by providing a possible explanation for this difference in duration.

Under the final title of this thesis, we will thoroughly analyse the regulation of short selling by the European Union, which was introduced in 2012. The European short selling regulation is twofold. On the one hand it constitutes a permanent restriction on short selling and a disclosure requirement. On the other hand, the European short selling regulation provides the authorities of its member states with a legal framework in which they can take emergency measures against short selling when necessary. Both aspects of the European regulation will be discussed. Finally, we will briefly address the legal action by the UK against this legal framework.

To conclude this thesis, we will raise the question whether regulators have drawn lessons from the financial crisis and the problems concerning the regulation of short selling during this crisis. Cautiously, we will estimate whether measures against short selling would be taken again if, or when, another financial crisis were to break out, and, if so, what form these measures would take on.

\(^3\) For example, in response to the financial problems of HBOS, a UK bank and insurance group and a parent company of the Bank of Scotland, former First Minister of Scotland Alex Salmond stated he was “very angry that we can have a situation where a bank can be forced into a merger by basically a bunch of short-selling spivs and speculators in the financial markets”. (X, “Salmond attacks financial ‘spivs’”, BBC News, http://news.bbc.co.uk/2/hi/uk_news/scotland/edinburgh_and_east/7621153.stm, 17 September 2008.)
Subtitle 1. What is short selling

Chapter 1. Definition

A short sale is the sale of a financial instrument which the seller does not own at the time of the sale. This construction allows the short seller to make a profit from a decline of the price of the financial instrument he sold. There are two types of short selling: covered and naked short selling. In a covered short sale, the short seller borrows the shares before selling them. In a naked short sale there is no such borrowing agreement.
Chapter 2. Naked vs covered short selling

Section 1. Naked short selling

Short selling becomes naked short selling when the short seller did not, by any means, borrow the shares before selling them. The short seller simply sells shares without owning them. To illustrate, we consider the following example:

An investor notices that there is a strong negative sentiment about a certain company. He wants to make a profit from this sentiment on a short term. On 1 November, without first owning or having borrowed them, he sells 10 shares of company A at the current market price of €10 per share. For this, he receives €100. Both parties agree that the shares will be delivered within three days. This is common, as it is accepted market practice that the settlement date, the date on which the shares are supposed to be delivered, takes place within three days after the transaction date. This means the short seller typically has three days to buy the shares he shorted and deliver them to the buyer. Of course, it is possible for the buyer and the short seller to agree that the shares are to be delivered on a later settlement date. The short seller is lucky and the negative sentiment keeps going, causing the share price to drop to €5 in only two days. The short seller wants to cash in so he buys 10 shares for a total price of €50, which he delivers to the buyer. He eventually makes a profit of €50.

Summary:

- **Revenues**
  - Sale of shares €100
- **Costs**
  - Purchase of shares €50
- **Profit/ loss** €50

Like any investment, short selling is not without risk. If the share price of Company A goes up, the short seller will suffer a loss. To illustrate we go back to the previous example, but now, instead of dropping to €5, the share price goes up to €15. This means the short seller now has

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4 The examples mentioned in this chapter are heavily simplified. In reality, there are often other costs involved, such as brokerage commissions or taxes.

to buy 10 shares at a total price of € 150, in order to deliver them to the buyer. He suffers a loss of € 50.

Summary:

- Revenues
  - Sale of shares € 100
- Costs
  - Purchase of shares € 150
- Profit/loss € - 50

If the investor does not have enough money to buy € 150 worth of shares, he will not be able to fulfil his commitment to deliver the shares when due. This is called a failure to deliver. This term is misleading because most failures to deliver are actually delays of delivery. The average failure to deliver lasts only 13 days for listed stocks and 56.6 days for unlisted stocks. The medians are even less: 2.9 days and 12 days respectively.

Section 2. Covered short selling

The short seller can avoid a failure to deliver by borrowing the shares or making arrangements to make sure they can be borrowed, when selling them. Typically, short sellers do not borrow shares before the short sale as doing so would lead to the payment of extra borrowing fees. Because of this, at the time of the sale, there is no observable difference between a covered short sale and a naked short sale. The European short selling regulation introduced in 2012, has put an end to this practice, requiring the short seller to cover his short sale before the actual sale.

On the settlement date, the short seller can simply deliver the borrowed shares to the buyer. In order to borrow shares, the short seller will enter into a securities lending contract with a third party. Securities lenders are typically entities who own a vast number of shares, such as pension funds, insurance companies, collective investment schemes and sovereign wealth funds.

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Through lending securities, these institutions have an extra source of income, on top of the revenues they receive from owning those shares. Some of the largest borrowers of shares are hedge funds and mutual funds.\(^1\)

After a lot of research, an investor finds out that the shares of company B are overvalued. He noticed that considering the financial health of company B, its shares are extremely expensive and still rising. He believes that in the foreseeable future, the market will correct itself and the share price of the company will go down. In order to make a profit out of this knowledge, the investor searches for someone who is willing to lend him 10 shares of company B, currently priced at €10 per share. He eventually finds a pension fund willing to do so for a fee of €1 per share. After borrowing them, he sells the shares at the market price of €10 per share. A year later the investor is inclined to give back the borrowed shares to the pension fund. Because he already sold them however, he has to buy new shares. Luckily for him, the share price of company B is now worth only €5. The short seller makes a profit of €40.

**Summary:**

- **Revenues**
  - Sale borrowed shares €100
- **Costs**
  - Lending fee €10
  - Purchase new shares €50
- **Profit/loss** €+40

Supposing, against the expectations of the short seller, the share price rises, he suffers a loss. For instance, if one year later the share price of Company B goes up to €150, the short seller suffers a loss of €60.

**Summary:**

- **Revenues**
  - Sale borrowed shares €100
- **Costs**
  - Lending fee €10
  - Purchase new shares €150

• **Profit/loss**

€ - 60

If in this case the short seller does not have the funds to buy 10 new shares at a total price of €150, unlike the naked short seller, the covered short seller will not fail to deliver to the buyer, as he already delivered the borrowed shares. The risk of insolvency of the short seller is now assumed by the securities lender and not by the buyer.11

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11 Note that it would have been cheaper and easier for the investor to engage in naked short selling instead of covered short selling, as he would not have had to pay a lending fee or find a shareholder willing to lend the securities to him.
Chapter 3. Legal definitions

Between jurisdictions, there are a lot of different interpretations of the term “short selling”. Many jurisdictions are only concerned about naked short selling, so there is no need for them to define short selling in general. Instead, they only define naked short selling. Other jurisdictions only offer a list of forbidden activities, in which a description of naked short selling is usually included.12 This also applied to Europe, until the European Union issued Regulation (EU) No 236/2012, with which the Union brought uniformity with regard to the definition of short selling.

Belgian legislation before 2012 did not use the term “short selling”, but spoke of uncovered transactions. In article 1 of the Royal Decree of 23 September 2008 establishing certain acts which constitute market abuse, these uncovered transactions are defined as follows:

“Transactions in shares or share certificates, executable on or outside the regulated market and regardless of whether they are cash transactions or future contracts, which are not fully covered at the time of the sale” and “transactions in derivatives with postponed delivery, which are not fully covered at the time of the sale”.

The Financial Securities Markets Authority (from here on called the FSMA)13, given the authority to do so14, explained in a ”questions & answers” on the website www.cbfa.be, that the seller of a share is fully covered in the following cases:

- The seller was in the possession of the securities, possibly by lending the securities;
- The seller will be able to supply the securities no later than three days after the day of the transaction;
- The seller bought the securities before selling them, and will receive them no later than three days after the day of the transaction.15

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13 At the time of issuance of the Royal Decree of 23 September 2008, the FSMA was still called the Banking, Finance and Insurance Commission (CBFA), since, on 1 April 2011, the CBFA became the FSMA. In this thesis, for the sake of consistency, we will speak of “the FSMA” when referring to either of both authorities. In the footnotes referring to documents published by any of these authorities, however, we will clarify which particular body published the documents concerned.
14 Article 1, 1° of the Royal Decree of 23 September 2008.
Taking into account the explanation offered by the FSMA, it is clear that the Belgian legislator only defined naked short selling, which it calls uncovered transactions. During a brief period in 2011, the FSMA changed its interpretation in such a way that the definition also concerned covered short selling.

Unlike the Belgian legislator, the UK legislator did provide for a definition of short selling. In its Financial Services Act 2010\textsuperscript{16}, the Parliament added the following definition for short selling to the Financial Services and Markets Act 2000:

“a transaction which creates, or relates to, another financial instrument and the effect (or one of the effects) of the transaction is to confer a financial advantage on [the short seller] in the event of a decrease in the price or value of the shorted instrument.”\textsuperscript{17}

In its definition of short selling, the Parliament did not describe the transaction itself, but instead defined the transaction on the basis of its result. Therefore, the definition of a short sale in the sense of former UK legislation, is much broader than the Belgian definition before the European regulation went into force.

The different definitions of short selling in the UK and in Belgium had an effect on short selling regulation during the financial crisis. The different views on what did or did not amount to short selling determined the scope the different regulations on short selling. As the Belgian legislation did not include covered short selling in its definition of short selling, covered short selling is outside the scope of its legal framework, whereas the definition given by the UK Parliament does keep the door open for regulation of both types of short selling.

\textsuperscript{16} Section 8(A) of the Financial Services Act 2010.
\textsuperscript{17} Section 131C(2) of the Financial Services and Markets Act 2000.
Subtitle 2. Types of short sellers

There are several types of short sellers, all with different motives for short selling: the speculator, the hedger, the market maker and the arbitrageur.18 The first type wants to make a profit out of the expected decline of a share price. The second type, the hedger, has an opposite motive, namely to curb potential losses caused by a certain security he owns. The third type, the market maker has a technical motive for short selling, as he wants to provide liquidity and stability to the market. Finally, the arbitrageur uses short selling as a way to profit if the price of a share on a certain exchange is different from the price of that same share on a different exchange.19

1. The speculator

The speculator believes a certain security is overrated and therefore expects a decrease of the price. However, the term ‘speculator’ does not accurately describe the first category of short sellers. As I will later explain, this type of short selling does not necessarily constitute speculation, as this insinuates that the investment is short-term, highly risky and/or purely based on price fluctuations. Therefore, the term ‘value arbitrageur’20 is more fitting, as the short seller makes a profit from a discrepancy between the price of the share and its underlying value. The discrepancy is called a pricing error. There is a variety of reasons why the short seller may believe the share price does not realistically represent its underlying value. A famous speculator-short seller is James Chanos, president of Kynikos Associates, an investment company specialised in short selling. In 1999, Chanos started doing research on the financial situation of Enron. Soon, he discovered that there was a discrepancy between Enron’s reported profits and its actual profits. In fact, Chanos calculated that Enron barely made any profits at all. So, according to him, not only was Enron heavily overrated, it was also committing fraud by actively making its investors believe otherwise. Convinced it was only a matter of time until the share price of Enron would reflect the real financial situation of the company, Kynikos

started short selling Enron shares. Given the fact that Enron eventually filed for bankruptcy, this has proven to be a highly lucrative decision.

Short selling can also be used as a means for profiting from changes in relative prices. In this case, the investor does not believe a certain stock A is overpriced in relation to the market, but in relation to another stock B. In this case, the investor, not knowing whether stock A is overpriced or stock B underpriced, will sell stock A short and buy stock B. If the investor turns out to be right and the market corrects the relative prices, either by a price decrease of stock A or a price increase of stock B, or both, the investor will profit from the relative price changes. This is called a ‘pairs trade’.

2. The hedger

The hedger-short seller is much different from the speculator-short seller. The latter exposes himself to risk by trying to make a profit out of an assumed price decrease, unlike the hedger, who only fears such a price drop will occur. Take for example an investor who has high stakes in companies listed on the London Stock Exchange. He is confident about the companies of which he bought shares, but has little knowledge about the economy of the UK. Knowing that if the UK economy falters, his shares would most probably be negatively affected, the investor wishes to reduce his exposure to the UK economy. The investor can do so by short selling the FTSE100 index. If the UK economy really does collapse, he will compensate the losses suffered by owning shares of UK companies by having closed a short position on the UK economy as a whole. Note that it was never the intention of the hedger to actually make a profit from the downfall of the UK economy. He merely wanted to minimize the losses he would suffer if this occurred. Investors also use short selling to hedge a position in other instruments than shares, for example by selling the underlying stock of a convertible bond short. Usually, the hedger will use derivatives in order to hedge his risks, for example by taking on a short position by buying a put option on his own shares. An option is a contract that gives the buyer the right, but not the obligation, to sell or buy a particular asset at a particular price, on or before a specified date. A put option gives the holder the right to sell, whereas a call option gives the holder the right to buy.

24 This definition was retrieved from: “Economics a-z”, The Economist, http://www.economist.com/economics-a-to-z.
3. The market maker

The main function of the market maker is to provide liquidity to the market. He does this by continuously being ready to buy shares from customers who want to sell, and sell shares to customers who want to buy. This avoids situations in which someone wants to buy a share but cannot find a seller and vice versa. The market maker does not pursue this noble cause for free however, as he buys at higher ask prices and sells at lower bid prices. This is called the bid-ask spread and is the main source of compensation for the market maker. Therefore, the market maker does not try to profit from the increase or loss in price of securities. When he short sells a certain share, he does not do so because he expects its price to drop. This is evident, because the market maker typically closes a short position within minutes or even seconds after opening it.\(^{25}\) The market maker only short sells when a customer wants to buy a share he does not own.\(^{26}\)

4. The arbitrageur

The arbitrageur makes a profit if the price of a share on a certain exchange is different from the price of that same share on a different exchange. When certain shares are cheaper on exchange A than on exchange B, the arbitrageur will buy these shares on exchange A and sell them on exchange B. By doing so, the price of the shares on exchange A will rise. The arbitrageur will keep sending buy orders until the shares on exchange A are no longer underpriced. Another way of profiting from this situation\(^ {27}\) is to sell the shares on exchange B, where they are worth more than on exchange A. Again, the arbitrageur will continue selling them until the share prices on exchange A and B are the same. As arbitrageurs trade with huge numbers of shares, it is unlikely that they do not own enough shares to sell on the more expensive exchange. Therefore, they will short sell these shares. Usually, arbitrageurs combine both buying and (short) selling to level the prices as efficiently as possible.\(^ {28}\)


\(^{27}\) This situation is called an arbitrage opportunity.

Title II: Motivations for and desirability of short sale regulations

The first documented regulation on short selling took place in the Dutch Republic. On 27 February 1610, following the crash of the Amsterdam Exchange, the Dutch parliament enacted the first ban on short selling. This was a reaction to an alleged fraudulent scheme by Isaac Le Maire, in which he and his accomplices sold shares of the Dutch East India Company short and manipulated the share price. In the late 1630s, in order to prevent the Dutch tulip mania from affecting its domestic market, the UK issued a ban on short selling. In the aftermath of the South Sea Bubble of 1720, another ban on short selling was installed. The House of Commons banned what is now known as naked short selling. This law remained active for 150 years. Nonetheless, naked short selling still widely occurred as the ban was ignored by investors and the government failed to intervene. Around the same time short selling was also banned in France after the collapse of the Mississippi Company and later, under Napoleon, even considered treason. In 2012, the European Union banned naked short selling after the financial crisis of 2008 shook the world.

History shows us that there is a clear tendency by law makers to hold short sellers responsible whenever a financial crisis occurs. It is highly doubtful that this is always a legitimate claim. Considering that in one year the shares of the South Sea Company rose almost over 1000%, that the South Sea Company gave out loans to people in order for them to buy more of its shares and that rumours about profits were spread, it is safe to say that short selling was not what caused the crisis. Yet it was banned for 150 years.

29 It is not clear if Le Maire actually did commit fraud besides short selling. There are strong indications that there was indeed a fraudulent scheme, such as his involvement in the setup of a French competing company, but it is likely that the government merely considered his short selling activities fraud.
Before analysing the regulation of short selling in Belgium, UK and Europe as a whole, an understanding of the possible motivations for such regulation is essential. There are three potential types of reasons for the regulation of short selling. First of all, the motives for regulating short selling can be economical of nature. If the costs of short selling for the economy are higher than its benefits, or if short selling impedes the economy’s stability, regulation is necessary. Whether this is really the case, will be made clear by an overview of the most important economic studies. Secondly, there may be ethical reasons for the regulation of short selling, as short selling is often deemed to be immoral. It speaks for itself that if short selling is intrinsically immoral, banning it would be perfectly justified. An analysis of the ethics of short selling imposes itself.
Subtitle 1. The economics of short selling

Under this subtitle, we will examine the potential economic motivations for restricting short selling and the effect thereof on the economy. Therefore, an understanding of the costs and benefits of short selling for the economy is essential. Without knowing the effects of short selling on the economy, an evaluation of the different motives for its regulation is impossible. In the first chapter, a short summary of the benefits of short selling will be provided. This will be followed by a summary of the most important studies on the effects of short sale restrictions on these benefits and therefore on the economy as a whole. The second chapter will consist of a list of the negative effects short sellers have (or are claimed to have) on the economy. These negative effects, however, can only serve as motives for regulation if such regulation can be expected to eliminate or decrease them. A brief summary of the most relevant economic studies on the subject should clarify this. To conclude, this newly acquired understanding of the effects of short sale restrictions on the economy will make it possible to evaluate the desirability of such restrictions.
Chapter 1. The benefits of short selling

On top of the advantages for the short seller himself, short selling has a number of benefits for the economy. Not only does it increase price efficiency, it also increases market liquidity. Furthermore, history has shown that short sellers are often the first ones to detect fraud committed by companies. Finally, covered short sellers are an important source of revenues for large shareholders as the latter can lend them their shares. In this section, these benefits will be analysed briefly and an overview of the most important studies will be provided.

Section 1. Price efficiency

It is proven that prices are closer to fundamental values when short sellers are more active. This way, short sellers are believed to significantly enhance price efficiency.\(^37\) Price efficiency can be defined as the degree to which prices reflect all available information in terms of speed and accuracy.\(^38\)

To illustrate how the price discovery process works, scholars often use the outcome of an election or referendum as an analogy for the price of a share.\(^39\) In an election, every participant has the opportunity to cast either a negative or a positive vote. If this were not the case, the election would be biased. Eventually, the result of the election is based on the totality of submitted votes. Just like votes in an election, every order on the stock market contains a value judgment. All these judgments together determine the share prices. Someone who submits a buy order of shares of a certain company can be assumed to have positive expectations concerning this company. As a result of this vote of confidence, the share price will go up.\(^40\)

On the other hand, someone might expect the share price of the abovementioned company to drop in the near future. In order to make a profit from the realisation of his expectations, he sells the shares of the company short. This will raise the supply of those shares and drive down the price. As short selling enables pessimist investors to express their opinions, it enhances

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40 This is because submitting a buy order increases the demand, which drives up the price.
price efficiency. In fact, the magnitude of the effect short selling has on price efficiency equals for example three times the effect of analyst coverage.\textsuperscript{41}

It is widely accepted among scholars that short sale restrictions impair the beneficial effect of short selling to price efficiency.\textsuperscript{42} To illustrate, we imagine a world without short selling, where investors’ only options are to buy or sell shares. If an investor has bad expectations concerning a certain company, he may choose to sell them. Of course, in order to do so he already has to hold some of its shares. In a world without short selling, the share price of the abovementioned company can be compared to the result of a flawed election. First of all, while everyone can submit a buying order, only shareholders can submit a selling order. The result of an election in which everyone can cast a positive vote but only a small group of people can cast a negative vote, cannot be expected to accurately represent the collective opinion of all these people. Secondly, we have to consider that submitting a selling order does not equal casting a negative vote, but merely a non-positive one. Someone who sells his shares most probably does so because he does not expect the share price of the company to go up anymore. This does not necessarily mean the investor thinks the share price will go down. It can also mean that the investor believes the share price will remain the same. In this regard, a stock market without short selling can be compared to a referendum in which voters are constrained to choose between voting yes and abstaining.\textsuperscript{43} A market in which short selling is completely banned, is a less efficient market. The same goes for markets with short sale restrictions instead of bans.

By making it more costly to submit a negative vote than a positive one, the results will also be biased.

The election-analogy indicates that short selling plays an important beneficial role to price efficiency by pushing down share prices\textsuperscript{44}. Consequently, restricting short selling should have detrimental effects to price efficiency. However, the exact consequences of such restrictions to


the price discovery process are heavily debated among scholars. According to MILLER, the existence of short sellers on the market drives down prices, as short sales increase the supply of stock on the market by the amount of the outstanding short position. Restricting short sales will therefore artificially drive up prices.\textsuperscript{45} DIAMOND and VERRECCHIA make a nuance to this theory and argue that short selling constraints do not lead to higher prices but merely reduce the speed to which prices adjust to new information.\textsuperscript{46} Consequently, according to them, the existence of short selling has no effect on the accuracy of the prices in the long term, but does enhance the speed of the price discovery process. The market will eventually correct an overvalued share, but it will do so more slowly. Another study which seems to contradict MILLER’s theory argues that restrictions on short selling often decrease share prices. BAI et al. find that restrictions on short selling increase uncertainty about the shares among less informed investors, which may lead to a decrease rather than an increase of the share price. In order for this to happen however, a certain level of uncertainty must have been reached. If this is not the case, one of the other theories still applies.\textsuperscript{47}

Even though scholars disagree on the exact effects of short sale restrictions on price efficiency, all agree that these effects are harmful. Even if we assume that short selling has no long term effect on share prices and that the market will eventually correct the temporary mispricing caused by restrictions on short selling, the effects of such restrictions may still be detrimental for the economy. It is obvious that when a company’s shares are artificially driven down because of government regulation, this company will suffer. The opposite is dangerous too, however. A company with overpriced shares may attract more investors than it would if its shares were not overpriced. This may cause investments which would normally have gone to healthier companies to go to unhealthy companies. Temporary overvalued shares may therefore cause long-term disruptions in the economy.\textsuperscript{48} There are plenty of examples of how overvaluation leads to long-term economic disruptions, such as the dot-com bubble or the South-Sea bubble.

Considering its massive impact on the economy, the damage to price efficiency caused by short sale regulations is something that should definitely be taken into account by regulators when introducing such regulations.

Section 2. Liquidity

Besides increasing price efficiency, short sellers also supply liquidity to the market.\textsuperscript{49} Liquidity can be defined as the ability to trade an asset quickly and at a low cost.\textsuperscript{50} In other words, liquidity describes how easily a certain asset can be exchanged for cash or liquidated.\textsuperscript{51} If an asset is highly liquid, it can be sold quickly, for a price that is close or equal to the asset’s value. In order to sell an asset that is illiquid, the seller will have to wait a long time to find a buyer who is willing to pay a price that is close to the asset’s real value, sell the asset for a price way below said value, or both. On the stock market, the liquidity of a share determines the bid-ask spread. The bid-ask spread is the difference between the price which someone is willing to pay for a certain share and the price for which someone will sell this share.\textsuperscript{52} The lower the liquidity, the higher the bid-ask spread will be. As they have to buy at the highest price and sell at the lowest price, a high bid-ask spread is bad for investors. It seems only logical that restricting short selling will decrease the beneficial effect of short selling on market liquidity. This could cause unwanted negative effects to the economy.

Section 3. Detecting fraud

It is often claimed that short sellers play an important role in detecting corporate fraud.\textsuperscript{53} But the question is whether this is really the case. It is plausible that a few famous but isolated cases\textsuperscript{54} give people the wrong idea about the frequency at which short sellers in fact detect


\textsuperscript{51} ““Economics a-z””, \textit{The Economist}, \url{http://www.economist.com/economics-a-to-z}.

\textsuperscript{52} ““Economics a-z””, \textit{The Economist}, \url{http://www.economist.com/economics-a-to-z}.

\textsuperscript{53} For example: M. JOHNSON, “Short selling’s new sultans take the stage”, \textit{Financial Times}, \url{http://www.ft.com/intl/cms/s/0/46f0cb26-b6d5-11e4-95dc-00144feab7de.html#axzz3V28tRJsn}, 16 March 2015.

\textsuperscript{54} For example the famous case of James Chanos who sold shares of Enron short or more recently investment firm Gotham City Research, which sold shares of Gowex short. (T. WORSTALL, “Gotham Shows the Value of Short Selling As Gowex Enters Bankruptcy”, \textit{Forbes}, \url{http://www.forbes.com/sites/timworstall/2014/07/06/gotham-shows-the-value-of-short-selling-as-gowex-enters-bankruptcy/}, 7 July 2014.)
fraud.\textsuperscript{55} DYCK et al.\textsuperscript{56} attempted to identify the most effective mechanisms for detecting corporate fraud by studying all reported fraud cases in large U.S. companies between 1996 and 2004. They found that there are some key players in detecting fraud, each accounting for more than 10\% of all detections:

- Employees: 17\%
- Short sellers: 14.5\%
- Media: 13\%
- Industry regulators: 13\%
- Auditors: 10.5\%

Taking into account that short sellers seem to have the strongest (monetary) incentive to detect fraud,\textsuperscript{57} DYCK et al. were surprised short sellers did not detect more cases of fraud. However, having detected 14.5\% of all fraud cases in the U.S. between 1996 and 2004, more than industry regulators or auditors, short sellers undoubtedly play an important role in detecting corporate fraud. Banning or even restricting short sellers can therefore be assumed to have a negative impact on the detection of fraud.

On the other hand, regulation can also enhance this important role of short sellers. By obligating short sellers to disclose their short positions, supervisory authorities will be able to detect fraud through short selling activities much earlier.

\textbf{Section 4. Extra revenues for stock lenders}

An investor who engages in covered short selling, will seek to borrow the share he plans to sell short. Therefore, he needs to find a shareholder willing to lend him a certain amount of these shares. Big shareholders such as pension funds, insurance companies and mutual funds, massively lend shares to short sellers. In doing so, they have an extra source of income. This practice benefits the shareholders of the insurance company or the clients of the pension or mutual fund, or at least it could.

However, the stock lender and consequently also its shareholders or clients, are exposed to the risk of insolvency of the borrower. Clients of mutual or pension funds are often unaware of the

\textsuperscript{55} This phenomenon is called the availability heuristic.
gravity of the lending activities by the fund manager and the risk they are exposed to. Furthermore, fund managers are believed to collect a large portion of the revenues from stock lending. A study on 19 UK mutual funds showed that only 66% of gross income from stock lending was being returned to the clients. As these revenues are obtained by lending the shares of the clients, this is a practice that should be gotten rid of.\textsuperscript{58,59}

Although securities lending is a source of extra revenues for some large institutions and its shareholders or clients, the latter should be informed about the risk they are exposed to and reap the benefits thereof. Making the disclosure of lending activities obligatory, would allow clients or shareholders to move their money to funds where they do receive the revenues from the lending of their stocks.\textsuperscript{60} Issuing disclosure requirements would therefore be a great first step towards creating a more fair situation, in which clients or shareholders of securities lenders get profits in return for the risk they run. Regulators could also go further and require fund managers to pass on the revenues from securities lending to their clients or shareholders.


\textsuperscript{59} Considering this problem, it could be argued that this aspect of short selling should not have been written under the section “benefits of short selling”, but instead under the section “downsides of short selling”. However, it is important to note that short selling merely makes it possible for large institutional shareholders to gain extra revenues. The fact that those institutions utilise this opportunity in a way that is unfair to its own shareholders is something only these institutions are responsible for, not short selling by itself.

\textsuperscript{60} For example to Vanguard, the largest mutual fund company in the world, which prides itself in passing on 100% of the revenues from securities lending to its shareholders.
Chapter 2. Downsides of short selling

Section 1. Market manipulation

In the previous section we have proven that short selling is in fact beneficial for the economy. Scholars agree that by itself, short selling has no costs for the economy. However, short selling ceases being beneficial to the economy when it serves as a means for market manipulation. Again, the problem lies not in short selling itself, but in its specific application in a certain situation. An example of such a manipulative form of short selling is spreading false rumours about a company after having it sold short. Although this surely is an effective strategy, it is also an illegal one in most countries. Another example is a bear raid. Here, a group of traders agree to massively sell a company short in order for its shares to decrease in price. Whether or not this company is financially unhealthy is of no importance for these short sellers. The main difference between regular short selling and a bear raid is that in the former case short sellers expect a certain share price to decrease by itself, while in the latter case short sellers try to cause the very same price decrease they wish to profit from. One could argue that it is impossible for short sellers to do so without spreading false rumours, because a bear raid would only lead to the temporary undervaluation of the shares of the ‘raided’ company. As shares are excessively cheap, other investors can be expected to take on long positions until the shares are again priced correctly. However, in a bear raid, short sellers are said to rely on self-fulfilling downward spirals. That way, the market is unable to correct itself.

Section 2. Predatory short selling

The existence of such self-fulfilling downward spirals has been the subject of many studies. Scholars seem to agree that short sellers cannot just randomly choose a company and raid it. Without the right circumstances, a bear raid is therefore certain not to be profitable. However,

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studies show that under certain circumstances, a self-fulfilling downward spiral may occur. BRUNNERMEIER and OEHMKE investigated whether it is possible for a trader to bring down a fundamentally solvent financial institution by selling it short on a large scale, which they call predatory short selling. As short selling leads to a drop in equity valuation, it causes non-insured depositors and short-term creditors to withdraw funding from the financial institution. This in turn may force the financial institution to liquidate long-term assets at exceptionally cheap prices, which decreases the overall value of this institution. Financial institutions can be vulnerable to predatory short selling when their balance sheets are weak.

It is clear that in this case, short sellers go further than merely bringing down prices of overvaluated shares to their correct levels. As under certain circumstances short sellers can cause serious harm to financial institutions and therefore to the economy as a whole, BRUNNERMEIER and OEHMKE state that temporary short sale restrictions for vulnerable financial institutions may be justified. They emphasise however that regulators should always do a balancing test between the benefits and the costs of such short sale restrictions.

The bulk of economic studies on short sale restrictions during the financial crisis of 2008 undermines the practical use of the theory of BRUNNERMEIER and OEHMKE. After the financial crisis, research has shown that short sellers were by no means the cause of the damage suffered by financial institutions. Studies show that short positions in financial institutions only increased significantly after bad news was made public. It can therefore be concluded that short sellers merely reacted to bad news, without causing or influencing it. Even though BRUNNERMEIER and OEHMKE proved short sellers may be the cause of damage to the financial institutions they target, no such incident has been proven to have occurred during the financial crisis of 2008. Yet, many countries struck by the financial crisis restricted the short selling of certain financial institutions. Studies seem to unanimously prove that these short sale restrictions not only were more damaging to the economy than they were beneficial, but also


had adverse effects on the companies they were meant to protect, causing their share prices to decrease even more.\(^6\)

Another model in which short sellers can trigger a self-fulfilling downward spiral was developed by ALLEN and GALE. According to these authors, an uninformed speculator can make a profit if other investors believe him to be informed.\(^7\) If an investor takes on a large short position in a certain company, others will follow if they believe the investor is well-informed. Whether the investor actually was informed or just randomly picked a company to sell short is irrelevant. The short seller will make a profit from other people following him, as they push down the share price. However, the theory of ALLEN and GALE applies to speculation in general, to taking on short positions as well as long positions. The dangers of artificially driving up the share price of a company are not less severe than those of the contrary. Therefore, even though they theorise it is possible for short sellers to harm a financially healthy company, the authors do not qualify this as a downside of short selling as much as a downside of speculative investing in general.


Chapter 3. Naked short selling

A form of short selling particularly targeted by regulators is naked short selling. As we will address later, the Belgian government only prohibited naked short selling during the financial crisis of 2008. Later, in 2012, the European Union also introduced a ban on naked short selling. In this chapter we will address why regulators might target naked short selling specifically.

Naked short selling is often considered more dangerous to the economy than covered short selling for a variety of reasons. First of all, what sets naked short selling apart from covered short selling is that the former can be done unlimitedly. In theory, it is possible for a naked short seller to sell more shares short than there actually exist. It is also much cheaper not to cover a short sale, as there are no borrowing fees to be paid. The lack of limits and cheapness of naked short selling can be expected to increase the likelihood of abusive short selling, in which short sellers work together to bring down a company and create a downward spiral from which they profit. There is little to no evidence the abovementioned risks have ever been externalised, however. Research has shown that there is no evidence that, during the financial crisis, naked short sellers have manipulatively precipitated price declines or contributed in any way to market distortions.

The danger of naked short selling that is most cited by regulators is the likeliness that it might lead to settlement failures. If the price of the shares he sold short has risen significantly or did not decrease as much as he hoped, it is possible a short seller is unable to deliver these shares. Alternatively, the naked short seller may never even have had the intention to deliver. In this case, his counterparty, the buyer of the shares, will not receive the shares he bought. The UK Financial Conduct Authority (FCA) stated that settlement failures may impair the proper functioning of the market, resulting in enhanced transaction costs and sub-optimal levels of trading. Lately, research has questioned the danger of settlement failures, however, as a study


72 Until April 2013, the current supervisory function of the FCA was exercised by the Financial Supervisory Authority (FSA). In this thesis, for the sake of consistency, we will speak of “the FCA” when referring to either of both authorities. In the footnotes referring to documents published by any of these authorities, however, we will clarify which particular body published the documents concerned.

by FOTAK, RAMAN and YADAV has pointed out a lack of evidence that such failures have caused price distortions or the failure of financial firms during the 2008 financial crisis.\footnote{V. FOTAK, V. RAMAN and P.K. YADAV, “Fails-to-deliver, short selling, and market quality”, \textit{Journal of Financial Economics}, vol. 114, 2014, 493-516.}

Although naked short selling goes along with several particular risks, the differences between the two transactions should not be exaggerated. In a study on the effects of short selling on the economy, FOTAK, RAMAN and YADAV show that naked short selling is just as beneficial to the economy as covered short selling is.\footnote{V. FOTAK, V. RAMAN and P.K. YADAV, “Naked Short Selling: The Emperor’s New Clothes?”, \textit{Working Paper}, \url{http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=4DAB046A1EE437C67E8B1A8B86938BB?doi=10.1.1.366.8421&rep=rep1&type=pdf}, 23-25.}
Subtitle 2. The ethics of short selling

The main reason people often consider short selling unethical is because short sellers profit when others lose money. An example can be found in an article of 2008 in The Independent, in which the author put forward that “making money as companies lose their value is simply profiting from other people’s misery”76.77 With “other people” the author probably meant the shareholders of the company, who see their shares decrease in value, and the employees, who might lose their jobs.

First of all, it needs to be said that a short seller does not simply profit from other people’s misfortune. In fact, a short seller profits from a situation that is a cause of misfortune for some, but also an advantage for others. For non-shareholders, a decrease of the price of a share can be a good thing, as it enables them to buy these shares for a cheaper price. In this regard, a distinction can be made between doctors and short sellers. Contrary to short sellers, doctors profit unabatedly from other people’s misfortune, as they only earn money when people get sick. Contrary to the decrease of a share price, in a normal situation, there is no positive aspect to sickness. So, whereas we can do so with regard to doctors, we cannot simply say that short sellers profit from other people’s misery, since a low share price is not a negative outcome by itself, contrary to sickness. This is a minor distinction, but a distinction nonetheless. The importance of this distinction and the degree to which it contributes to the morality of short selling is not completely clear. Because I will prove that short selling is not unethical, I will neglect this distinction and assume that short sellers do actually unabatedly make a profit from other people’s misfortune, therefore imposing onto myself the heaviest burden of proof.

There is not much literature about whether profiting from someone else’s misfortune or suffering is ethical or not. In the few works that have been written about this matter, scholars seem to agree that there is nothing unethical about doing so, as long as the person who profits

76 The misfortune of these people has no direct influence on the profits of the short seller. Unlike the doctor who needs his patients to feel sick in order for them to pay for a consultation and therefore requires his patients to be misfortunate, the short seller only makes a profit from a situation in which some people are certain to be misfortunate. In the example of the doctor, the illness of a patient leads to revenue for the doctor. This is a minor distinction, but a distinction nonetheless. The importance of this distinction and the degree to which we can see the cause of guaranteed misfortune apart from the misfortune itself is not completely clear. As I will prove that short selling is not unethical, I will neglect this distinction and assume that short sellers do actually make a profit from someone else’s misery, therefore imposing myself to the heaviest burden of proof.

does not cause the suffering from which he profits. This condition needs no further explanation as nobody would deny that it is immoral to cause others to suffer.  

Based on this principle and given the agreement among scholars with regard to the benefits of short selling to the economy and the fact that only in exceptional circumstances short selling may be damaging to the shorted company, we can conclude that, in essence, there is nothing immoral about short selling.

In general, the principle that it is morally acceptable to profit from someone else’s misfortune as long as the person who profits does not cause said misfortune, does not seem subjected to much opposition, since people witness such occurrences almost daily, without any protest. It is undeniable that a great deal of businesses profit from other people’s misfortune, without anyone considering those businesses immoral. We previously used the example of doctors making a profit from people getting sick. The same applies to the pharmacy industry. The morality of either of these examples is ever subjected to doubt. We can go even further and state that basically every business, one way or another, profits from some form of misfortune. Supermarkets for example make a profit when people are hungry and need food.

One could raise the moral bar and argue that it is only acceptable to profit from someone else’s misfortune if the person who profits (actively) makes the situation of the unfortunate person better. Pharmaceutical companies and hospitals help cure people from diseases, supermarkets help people still their hunger, but short sellers do not help the shareholders who see their shares lose value in any way. Again, however, short sellers are not the only ones profiting from other people’s problems without solving them. Rarely, moral objections are raised when a newspaper reports on (fatal) car accidents, homicides, war or famine. In none of these cases does the newspaper company directly influence the situations of the victims. The reason why no moral questions are raised, may be because, as IRVINE states, it is not immoral to profit from someone else’s suffering, as long as the person who profits does not cause (more) suffering. IRVINE goes even further by stating that it is even morally acceptable to wish for something bad to happen, in order to profit from it. The fact that there are abusive short sellers who do cause

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78 There are of course certain exceptions to this moral principle, in which it is necessary or justified to cause suffering. These exceptions are however irrelevant here.
the misfortune they profit from by spreading false rumours or by working together in order to bring down a perfectly healthy company (i.e. a bear raid) does not change anything to the fundamentally morally acceptable nature of short selling.

However, beneficial as short selling may be for the economy as a whole, it is undeniable that high short selling activity with regard to a certain share, does bring down the share price and therefore contributes to the misfortune these short sellers profit from, i.e. the losses suffered by the shareholders. In my opinion, however, if short sellers notice a certain share is overpriced and drive down the price to its realistic value, the short sellers cannot morally be held responsible for the losses suffered by the shareholders. These shareholders themselves are responsible by making the initial fault of buying or holding overpriced shares. Short sellers cannot be blamed for fixing what is wrong, namely the price of an overvalued share. Moreover, as we have addressed earlier, short sellers merely accelerate the process of price adjustment, as eventually the market will realise that the share price does not realistically represent the underlying value of the company.\footnote{This is demonstrated under Title II, Subtitle 1, Chapter 1, Section 1: “Price efficiency”, on pages 12 to 15.} In this regard, short selling does meet the condition set forward by IRVINE, as it is not the cause of misfortune. Therefore, short selling is intrinsically ethical.
Subtitle 3. Short selling regulation as a means for restricting speculation?

Short sellers are often depicted as speculators who, based on rumours or a hunch, bring down whole companies in order to make a profit. As speculation is often (rightfully) blamed for financial crises, short sellers seem to illustrate exactly what is wrong with the financial market. But even John C. BOGLE, founder of the Vanguard Group, one of the largest mutual fund companies in the world with about $ 3 trillion in assets, who is famous for his aversion to speculation, is opposed to “substantive limits on short selling.” The truth is, short selling is not necessarily more speculative than any other investment. The Economist describes the difference between speculation and regular investing as follows: “speculation involves buying or selling a financial asset with the aim of making a quick profit”, unlike “long-term investing, in which an asset is retained despite short-term fluctuations in its value”. A covered short sale does not by itself meet this condition. Entering into a securities lending agreement allows the short seller to hold his position for a long period of time in order to have a more long-term investment in mind. Because the settlement date typically takes place within three days after the transaction date, a naked short sale is not assumed to have a duration of more than three days. However, naked short sellers often (deliberately) fail to deliver, hence prolonging the duration of the short sale. Yet, the duration of this failure to deliver is typically not more than a few days. Still, naked short selling can be part of a long-term design if the short seller continuously sells short over a long period of time. In his prepared statement for the U.S. Securities Exchange Commission, James Chanos argued that short sellers typically have to hold their short positions for a long period of time, because it often takes months until the market realizes a certain share is overrated. In this respect, short selling does not by itself qualify as speculation, as it is not necessarily a short-term investment. There is no evidence that suggests that short sellers are more speculative than investors who assume long positions. Therefore,

regarding the time short sellers hold their positions, there is little reason to consider short selling more speculative than simply buying shares.

Another way the distinction between investing and speculating is often made, is by the amount of risk involved. Managing and minimizing risk is an important aspect of investing, whereas speculation is characterized by higher risks. For example derivatives such as options are far more risky than regular shares, as there is a higher chance that they end up losing all their value. On the other hand, because of a leverage effect, the returns can be significantly higher. Short selling has no such leverage effect. The revenues or losses the short seller makes are proportional to the increase or decrease of the share price, only reversed. Yet, short selling is slightly riskier than just buying shares. When you buy a share, you cannot suffer a loss higher than 100%, as a share cannot have a negative value. On the other hand, the share price can rise indefinitely. This means that in theory it is possible for the short seller to lose more than 100% of his investment. Considering that the short seller can close his position whenever he wishes, the chance that a short seller loses more than 100% of his investment seems rather small. The naked short seller also runs the risk of not being able to find shares to buy, after having sold them short. If this happens, the naked short seller will be unable to close his short position. Such a situation normally only occurs when trading in illiquid shares. On the other hand, investors who take on a long position in an illiquid stock run the same risk, as they may be unable to find a buyer for their shares.

We can conclude that even though there are some indications that short selling is speculation, short selling may be just as speculative as any other investment. On the contrary even, given the many restrictions and costs, such as the lending fee for covered short selling, it is argued that the short seller is more inclined to look before he leaps. Given those extra costs, generally speaking, investors who engage in short selling can be expected to have stronger beliefs or expectations concerning the future share price of a company than ‘regular’ investors who assume long positions in a company. Regulating short selling in order to limit speculation therefore makes little sense.

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Title III: Short selling regulations during the financial crisis in Belgium and the UK

When the financial crisis struck Europe, the regulation and supervision of financial market activities, such as short selling, was heavily fragmented. On a European level, only the Market Abuse Directive 2003/6/EC restricted short selling, by making activities such as spreading false rumours or using insider information illegal.\(^91\) By only prohibiting such abusive forms of short selling, non-abusive short selling remained an activity regulated by the member states. This thesis serves as an illustration of the regulatory fragmentation in Europe by describing how regulators in Belgium and the UK reacted to the financial crisis in terms of short selling regulation, by comparing these respective regulations of both countries with each other and finally by estimating how these different approaches may have had different effects on the economy.

Subtitle 1. Introduction

The bankruptcy of investment bank Lehman Brothers on 15 September 2008, defining the climax of a global financial crisis, was for regulators all over Europe and the rest of the world yet another example of the dangers of short selling. Among the measures taken by all regulators, two types can be observed: the prohibition of short selling in a certain form and an obligation to disclose one’s short position to the market and/or the authority. In Table 1 in the Annex to this thesis, an overview is provided of how and when countries all over the world introduced short selling regulations.

The UK’s Financial Conduct Authority (FCA) was one of the first to react. On 18 September 2008, it issued a press release stating that it intended to issue restrictions on short selling in cooperation with the American SEC.92,93 The Belgian FSMA followed quickly with a press release of its own, concerning future regulation of naked short selling.94

Both the Belgian FSMA and the UK FCA took two types of measures. One of those measures was the instalment of a disclosure rule. One of the first in Europe, the FCA had already announced such a disclosure rule on 12 June 2008, which came into force on 20 June of that year.95,96 In September of the same year, the Belgian FSMA announced a similar disclosure rule. The fall of Lehman Brothers, however, raised the concern that disclosure rules were not sufficient and both the FSMA and the UK announced a prohibition of short selling.

In this chapter we will analyse the regulation of short selling by the UK and Belgium. We will not only describe the respective short sale regulations, but also compare the two with each other and hypothesise how the differences between both regulations had an impact on investors and the economy as a whole. Economic studies after the financial crisis on the impact of short selling regulation during this crisis will serve as support for the hypothesis made. In the first section of

96 This rule reportedly was the consequence of the FSA’s disapproval of Deutsche Bank’s advice to its clients to short sell the stocks of British banks. (P. ALDRICK, “FSA angered by Deutsche Bank’s ‘crass’ short selling advice”, The Telegraph, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2791853/FSA-angered-by-Deutsche-Banks-crass-short-selling-advice.html, 18 June 2008.)
this chapter, we will thoroughly study the prohibition of short selling in the UK and Belgium. Subsequently, we will assess the disclosure rules in both countries.
Subtitle 2. Objectives

Unlike regulators in other countries (e.g. Singapore), the FSMA and FCA were not focused on the prevention of failures to deliver. Their main goal was to prevent price manipulation and to stop investors from driving down the prices of shares in vulnerable financial institutions.\(^97\)

In the press release announcing its measures against short selling, the Belgian FSMA referred to the exceptional market conditions and stated the new measures were “aimed at maintaining a consistent regulatory framework among the various financial markets and at avoiding abusive arbitrage”.\(^98\) Hereby, the FSMA refers to the fact that short selling restrictions were introduced in most European countries. In order to maintain regulatory consistency, the FSMA therefore considered the introduction of a short sale constraint in Belgium necessary. When implementing the announced measures by issuing the Royal Decree of 23 September 2008, the Belgian government repeated this reasoning.

In the press release, the FSMA further justified its measures against short selling by pointing out the dangers of short selling for the economy:

“*These measures serve to ensure the integrity and smooth operation of the markets. They are, in particular, aimed at preventing the execution of transactions which give or are likely to give false or misleading signals regarding the supply of, demand for or price of financial instruments, as provided for in Article 25 of the Law of 2 August 2002.*”

In the Royal Decree of 23 September 2008, the Belgian government mainly took over the reasoning of the FSMA. The government stated that “[…] the current turbulence in the financial markets [required] immediate regulatory measures that [contributed] to the protection of the integrity and the smooth operation of the markets and the strengthening of investor confidence”.\(^99\) When assessing the dangers of short selling, the government went even further than the FSMA by claiming that short selling formed “acute danger for the smooth operation and integrity of the markets”.\(^100\)

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\(^99\) This citation was translated from Dutch. Original text: “[…] de huidige turbulente situatie op de financiële markten [vergt] zonder verwijl reglementaire maatregelen […] om bij te dragen tot de bescherming van de integriteit en de goede werking van de markten en tot de versterking van het beleggersvertrouwen”.

\(^100\) This citation was translated from Dutch. Original text: “een acuut gevaar […] voor de goede werking en de integriteit van de markten”.
In the UK FCA’s press release announcing the new regulation of short selling, Hector Sants, chief executive of the FCA, made the following statement:

“While we still regard short-selling as a legitimate investment technique in normal market conditions, the current extreme circumstances have given rise to disorderly markets. As a result, we have taken this decisive action, after careful consideration, to protect the fundamental integrity and quality of markets and to guard against further instability in the financial sector.”

Whereas the Belgian FSMA, in its announcement of the new short selling regulation, pointed out the dangers of short selling to the market, the FCA refrained from doing so. Instead, they point out the legitimacy of short selling as an investment technique. According to the FCA however, disorderly markets made measures against short selling necessary.

In a discussion paper after the expiration of the short selling measures, the FCA explained how short selling could lead to or further aggravate these disorderly markets. Pointing out that short selling could be a signal of the overvaluation of a certain stock, the FCA believed that because there was a high risk that other investors would overreact to this signal, short selling could lead to excessive circumstances. This way, short selling would become a self-fulfilling prophecy. Additionally, related stocks would suffer too.

Yet, the FCA remained ambiguous about the role it suspected short selling to have in the financial crisis, as it admitted that even though “some observers” had called short selling a major contributory factor, it had not found conclusive evidence to support that hypothesis.

We assume that there was significant pressure on both countries to introduce restrictions on short selling. With the majority of European countries introducing all different types of bans on short selling, it was hard for a single country to stay behind. By doing so, this country runs the risk that short sellers all over Europe turn their attention to the stocks of its financial institutions. This concern is reflected by the statement of the FSMA that by installing the short selling measures in Belgium, the FSMA wished to avoid abusive arbitrage. The fact is that the short selling measures taken by the FSMA are part of a European-wide wave of national regulations on short selling. The FSMA alluded to this by opening its press release on 19 September 2008

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with the claim that the initiative to regulate short selling was the result of a consultation with the other supervisory authorities responsible for the supervision of Euronext.¹⁰⁵ The UK FCA in turn worked in concert with the Securities Exchange Commission of the United States (US SEC).¹⁰⁶

Subtitle 3. The specific measures taken in Belgium and the UK

Chapter 1. The disclosure requirement

Section 1. The UK disclosure rule of June 2008

On Tuesday, 29 April 2008, banking and insurance company HBOS, plagued by a strong price decrease of its shares\(^{107}\), issued shares in order to raise £4 billion in capital.\(^{108}\) Shortly after, the shares of HBOS plunged. Once again, short sellers were believed to have caused the company’s downfall and new regulations on short selling were installed.\(^{109}\) As later turned out, however, HBOS had failed to mention in its prospectus, a 194-page document supposed to detail all possible risks to potential funders, that the company was being supported by the state for billions of pounds in order for it to survive.\(^{110}\)

The new regulation on short selling following the downfall of HBOS in June 2008 was specifically aimed at the short selling of shares of a company that had announced the issuance of (new) shares. On 12 June 2008, the FCA added article 1.9.2A to the Code of Market Conduct, which came into force on 20 June 2008 and qualified the following activity as market abuse:

“Failure by a person to give adequate disclosure that he has reached or exceeded a disclosable short position where:

1. that position relates, directly or indirectly, to securities which are the subject of a rights issue; and

2. the disclosable short position is reached or exceeded during a rights issue period.”\(^{111}\)

In the Glossary of definitions in the Financial Conduct Authority Handbook, the term “disclosable short position” was defined as follows:

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\(^{107}\) In March 2008, the share price of HBOS decreased by 17%.


\(^{111}\) FSA 2008/30, “Short Selling Instrument 2008".
“a short position which represents an economic interest of one quarter of one per cent of the issued capital of a company.”112

The FCA gave the term “rights issue period” the following definition:

“The period that commences on the date a company announces a rights issue and which ends on the date that the shares issued under the rights issue are admitted to trading on a prescribed market.”113

It is clear that the disclosure rule only applies to short selling of shares of companies conducting rights issues, such as HBOS in April 2008. This measure was supposed to provide those companies that were already in need of a capital injection with extra protection against abusive short selling. Because of the disclosure rules, the FCA would more easily detect such abusive activities and could therefore intervene more rapidly.

The FCA’s move against short selling was subject to much debate. Guy Sears, director of the Investment Management Association, applauded the disclosure rule, stating: “Manipulating rights issues is not a game; it damages the wider economy and jeopardises mid-term recovery [...] short so as to suppress the share price below the underwritten price, knowing this will force underwriters to sell at a discount, is fuelled by an absence of transparency”. Simon Denham, on the other hand, director of Capital Spreads, opposed the new regulation. He said: “The whole reason that companies need to make rights issues (in many cases) is because they are in trouble. To restrict short selling stock in these circumstances seems perverse in the extreme”.114

Section 2. The Belgian and UK disclosure rules of September 2008

Following the fall of Lehman Brothers, the FCA realised that not only companies raising capital needed protection against short sellers. All over Europe, disclosure requirements were imposed on short sellers of financial sector stocks.

Just like it did for the introduction of the prohibition of short selling, the Belgian government used the authority it received by the legislator in art. 25, § 1, 5° of the Law of 2 August 2002 in order to introduce its disclosure rule. Since the legislator only provided the government the authority to identify certain activities as market abuse and therefore prohibit them, this seems odd. In no way did the legislator intend to give the government the authority to create a

disclosure rule. Yet, this is exactly what the government did, by qualifying the following activity as market abuse in article 3 of the Royal Decree of 23 September 2008:

“The act of not continuously notifying a net short position representing more than 0.25 % of the voting shares of an issuer in the financial sector to the [CBFA] and the market”115

By prohibiting the default of disclosing under certain circumstances, the Belgian government in fact installed a disclosure requirement.

The UK government also made use of the regulation of market abuse regulation in order to introduce its disclosure requirement. Article 1.9.2D of the Code of Market Conduct qualified the following behaviour as market abuse in the sense of section 118(8) of the Financial Services and Markets Act:

“Failure by a person who has a disclosable short position in a UK financial sector company to provide adequate ongoing disclosure of their position”.116

In the Glossary of definitions of the Financial Conduct Authority, the FCA changed the definition of a “disclosable short position”, previously established within the framework of the disclosure rule of 12 June 2008, into the following definition:

“A net short position which represents an economic interest of one quarter of one per cent or more of the issued capital of a company”117,118

In Belgium as well as in the UK, the short seller was required to disclose his short position no later than the next business day after the date on which the disclosable short position was reached.119,120

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115 This citation was translated from Dutch and French. Original text in Dutch: “het niet doorlopend aan de CBFA en aan de markt melden van een gecumuleerd netto-economische baisse-positie, die meer bedraagt dan 0,25 % van de stemrechtverlenende aandelen van een emittent in de financiële sector”; original text in French: “le fait de ne pas notifier en permanence à la CBFA et au marché toute position économique nette cumulée à la baisse supérieure à 0,25 % des actions avec droit de vote d’un émetteur du secteur financier, conformément à la disposition énoncée ci-dessous”.
118 The underlined words indicate the changes made to the previous definition.
120 Article 3 of the Royal Decree of 23 September 2008.
Chapter 2. The prohibition

Section 1. The Belgian prohibition rule

The Belgian FSMA’s announcement of 19 September 2008 to take measures against short selling, was made binding by the “Royal Decree of 23 September 2008 on certain operations constituting market abuse”.¹²¹ In order to do so, the Belgian government relied on the “Law of 2 August 2002 on the supervision of the financial sector and the financial services”.¹²² Article 25, § 1 of this law provides a list of activities that constitute market abuse and are therefore forbidden. This list is not exhaustive, however, as article 25, § 1, 5° provides the King (read: the government), advised by the FSMA, the authority to identify, and therefore prohibit other activities that impede or disturb the integrity and transparency of the market or are able to do so.

In article 2, 1° of the Royal Decree, the first forbidden activity was described as follows:

“Uncovered transactions in issuers of the financial sector, of which the shares or share certificates are admitted to trading on a Belgian regulated market”¹²³,¹²⁴

Article 1, 1° of the same Royal Decree identified two types of “uncovered transactions”:

a) “orders for transactions in shares or share certificates executable on or outside the regulated market, regardless of whether they are cash transactions or futures transactions, of which there is no full coverage at the time of the sales order;

b) orders for derivative transactions with deferred settlement for which there is no full coverage at the time of the order.”¹²⁵

¹²¹ The title of this Decree was translated from Dutch. Original title: “Koninklijk Besluit van 23 september 2008 tot vaststelling van bepaalde handelingen die marktmisbruik uitmaken”.
¹²² The title of this law was translated from Dutch. Original title: “Wet van 2 augustus 2002 betreffende het toezicht op de financiële sector en de financiële diensten”.
¹²³ In an annex to the Royal Decree of 23 September 2008, a list of the protected financial institutions was provided. This list contained only five names: Dexia SA, Fortis NV/SA, ING Group NV, KBC Ancora SCA, KBC Group NV.
¹²⁴ This citation was translated from Dutch. Original text: “ongedekte transacties in emittenten van de financiële sector, waarvan de aandelen of aandelencertificaten toegelaten zijn tot de verhandeling tot een Belgische gereglementeerde markt”.
¹²⁵ This citation was translated from Dutch. Original text: “(a) orders voor transacties in aandelen of aandelencertificaten uit te voeren op of buiten de gereglementeerde markt, ongeacht of het gaat om contante transacties of transacties op termijn, waarbij op het tijdstip van het verkooporder geen volledige dekking voorhanden is;

b) orders voor derivatentransacties met uitgestelde levering waarbij op het tijdstip van het order geen volledige dekking voorhanden is”.

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In our opinion, the Belgian regulator was not completely clear in its wording, as the term “full coverage” is ambiguous. It is possible that by requiring “full coverage” the regulator wished to require the seller of a certain share to actually own these shares when selling them. This interpretation of the term “full coverage” would have led to the Royal Decree forbidding both naked and covered short selling. However, with “full coverage”, the regulator could also have meant that the seller of a share had to at least borrow those shares before the sale. This interpretation would only have led to a ban on naked short selling. In conclusion, the scope of the prohibition depended on the interpretation of the term “full coverage”. The FSMA, given the authority to do so by article 1, 1°, section 3 of the Royal Decree, gave such an interpretation, stipulating that an investor was fully covered if he met one of the following conditions, before selling the concerned securities or creating a short derivative position:

1. the investor is in possession of the securities, including by a securities lending agreement;
2. the investor will be able to deliver the securities no later than three days after the transaction date due to pre-existing securities lending agreements;
3. the investor already bought the securities, which will be delivered to him no later than three days after the transaction date.

By this interpretation, the FSMA clearly indicated that the prohibition targeted naked and not covered short selling. In its interpretation of “full coverage”, the FSMA gave investors a few ways of covering a short sale. The first condition stated that the short seller had to be in possession of the securities before selling them, which meant that he had to either own or have borrowed them. The second condition made it possible for an investor to sell a certain share short without possessing it on the sole condition that the investor had previously entered into a securities lending agreement that allowed him to deliver the shorted share within three days after the sale. The third condition seems a bit out of place, however, as a transaction in compliance with this condition cannot constitute a short sale. According to this third condition, the investor must have bought the share before selling it, which cannot be the case in a short sale. The Belgian regulator presumably just tried to make it clear that the prohibition of short

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126 The CBFA used this interpretation from 12 August 2011 on, in order to prohibit both naked and covered short selling. This will be addressed in chapter 8 of this title: “Regulatory changes following the fall of the stock markets in August 2011”, on page 58.
selling was not intended to keep investors from selling shares they had already bought but were not delivered yet, as this would greatly impede market liquidity.

The term “uncovered transactions” used by the Belgian regulator differs from the definition we gave to naked short selling earlier in this thesis. The Royal Decree of 23 September 2008 describes two types of uncovered transactions. Whereas the first type of uncovered transactions, in the sense of article 1, 1°, a of the Royal Decree of 23 September 2008, does in fact refer to regular naked short selling as we have defined it in the beginning of this thesis, the second type involves the use of derivatives. With the latter type of uncovered transactions, the Belgian regulator wished to target investors who took on a short position by trading in derivatives such as put options. To illustrate how an investor can do so, we will explain the use of a put option as a means for shorting a share.

By holding a put option, an investor has the right to sell an underlying share at a predetermined price. This use of such an option can serve two purposes: a hedging or a speculative purpose. In the first case, an investor who owns shares of a certain company may expect a temporary decrease of the price of his shares. In order to reduce the risk of losing money because of this expected price decrease, he can buy a put option on the shares he owns. By doing so, the investor has the right to sell the underlying shares at a predetermined price within a certain period of time or at a certain date in the future. The investor has now reduced his exposure to the expected price decrease, as he can sell his shares at the predetermined price if such a price decrease occurs. This transaction clearly does not qualify as an uncovered transaction however, as the investor is covered in the sense that he owns the shares he takes a short position in.

An investor can also hold a put option for speculative purposes. In this case, the investor does not own any of the underlying shares. This would be illogical, as he believes their price will decrease. The investor holding a put option for speculative purposes will wish to see the underlying shares to drop in price, so he can sell them at a predetermined price higher than their actual price at the time of the sale. The profit he makes from this transaction is the difference between those two prices, subtracted by the purchase cost of the put option. By requiring a derivative transaction like this to be covered, the Belgian regulator requires the investor holding a put option for speculative purposes to first enter into a securities lending agreement for the

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128 This definition can be found under title I, chapter 1, section 1.2., Chapter 2. Naked vs covered short selling.
underlying shares of the option. The cost of such coverage is considerable and will significantly reduce the leverage effect of the option.

In a Q&A about the new short selling rules, the FSMA determined that the prohibition also applied to transactions or combinations of transactions that fell outside the scope of the Royal Decree of 23 September 2008 but had the same effect.\textsuperscript{129} With this provision, the FSMA exceeded its authority, as art. 25, § 1, 5° of the Law of 2 August 2002 states that only by Royal Decree certain activities can be prohibited.\textsuperscript{130}

**Section 2. The UK prohibition rule**

In the meantime, the FCA, which had already issued a disclosure rule for short sellers, had deemed this rule insufficient for the protection of the market, and also announced a prohibition of short selling.

The legal framework of the short selling prohibition in the UK was similar to that of the Belgian prohibition. Like the Belgian Law of 2 August 2002, the UK Financial Services and Markets Act contains a list of forbidden activities that the legislator qualifies as market abuse.\textsuperscript{131} Article 119 of this Act authorises the FCA to prepare and issue its Code of Market Conduct, in which it may describe behaviour that, in the opinion of the FCA, amounts to market abuse. In order to prohibit short selling, the FCA added article 1.9.2C to the Code of Market Conduct:

“A person who enters into a transaction that (whether by itself or in conjunction with other transactions) has the effect of:

a) creating a net short position in a UK financial sector company; or

b) increasing any net short position in a UK financial sector company that the person had immediately before 19 September 2008;

is, in the opinion of the [FCA], engaging in behaviour that is market abuse (misleading behaviour).”\textsuperscript{132}

\textsuperscript{129} This Q&A could previously be found on the website of the CBFA (CBFA, “Q&A about new short selling rules announced by the CBFA (update)”, \textit{www.cbfa.be}, 28 May 2009, A.6.) but is now removed from this website. In the article “The Prohibition of Short Selling. The Belgian Regulation and European Developments” by BOGAERT, much of the content of the concerned Q&A is documented, however.


\textsuperscript{131} Section 118 of the Financial Services and Markets Act 2000.

\textsuperscript{132} FSA 2008/50, “Short Selling (No2) Instrument 2008”.
The following definition of a “net short position” was added to the Glossary of the Financial Conduct Authority Handbook:

“A net short position which gives rise to an economic exposure to the issued share capital of a company.

Any calculation of whether a person has a short position must take account of any form of economic interest in the shares of the company.”

Although this definition clarifies that the net short position has to give rise to economic exposure and that any form of economic interest must be taken into account when evaluating this position, the definition is deficient. This is because the FCA makes the mistake of using the term to be defined in the definition itself. Nevertheless, the meaning of the term “net short position” is clear. A net short position is simply the negative result after subtracting a short position from a long position. The European Securities Markets Expert Group (ESME) explained it as follows:

“A net short position is calculated by netting off short positions in shares or other financial instruments (whether naked or covered) against long positions held by the seller. Shares held under a stock loan agreement are not considered to be a long position, so a borrower who sells borrowed stock will create a short position.”

The UK’s short selling prohibition was fundamentally different from the one in Belgium.

**Section 3. Resemblances and differences between the Belgian and UK prohibition rules**

**Subsection 1. Different types of prohibitions in Europe**

It is hard to evaluate which prohibition was more strict than the other. Fact is that the approaches of the Belgian and the UK regulators were completely different. Even though both types of short selling restrictions serve a common purpose, namely the prevention of price manipulation and the protection of vulnerable financial institutions from the effects of short selling, the different approaches taken by both regulators had different consequences to investors in Belgium and in the UK.

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In a report of 19 March 2009, the ESME observed the following three main types of short selling restrictions in Europe:

1. a restriction on the creation or increase of a net short position;
2. a ban on naked short sales of physical shares;
3. a ban on naked short sales of physical shares and financial instruments giving an economic exposure to the underlying shares.\textsuperscript{135,136}

Subsection 2. Comparison

The measure announced by the FSMA was the prohibition of naked short selling of shares of financial institutions traded on Euronext Brussels. Therefore, it was initially expected to belong to the second type of short selling restrictions. However, when converting the announced restriction in actual regulation, the Belgian government went further and also forbade “orders for derivative transactions” without full coverage. In that regard, the Belgian regulation on short selling during the financial crisis belonged to the third type, according to which not only the naked short selling of physical shares was forbidden, but also naked short sales of financial instruments giving an economic exposure to those shares. The derivatives referred to in the Belgian regulation, such as put options or futures, give such an economic exposure to the underlying shares, as their prices increase or decrease as the price of the underlying shares increase or decrease, be it with a leverage effect. Later, in 2011, the FSMA also banned covered short selling.

Whereas the FCA’s disclosure provision was similar to the one taken by the FSMA, its prohibitory provision was not. The FCA did not simply forbid (naked) short selling, but instead banned “the active creation or increase of net short positions in publicly quoted financial companies”. The restriction imposed by the FCA thus belonged to the first type of short sale restrictions. The FCA explained that with “net short position” they meant “any net short position [leading] to an economic exposure to the issued share capital of a listed company”.\textsuperscript{137} This meant that derivatives, such as options or futures, also had to be taken into account when calculating a the net short position.\textsuperscript{138}

\textsuperscript{136} The ESME noted that it had perceived significant variations within these categories.
In a discussion paper of 2009, the FCA defended its approach for banning short selling by criticising the prohibition of naked short selling. According to the FCA the prohibition of naked short selling would impair the proper functioning of market makers, who have to sell stocks short in order to meet client demand for this stock when their own inventories are exhausted. This impediment is not impossible to overcome, however, since many other countries who installed a ban on naked short selling, such as Belgium, exempted market makers from this ban. The FCA also questions whether naked short selling is really the source of problems. Legitimately so, since naked short selling and covered short selling have a fundamentally similar impact on the economy.

Chapter 3. Soft law

When announcing its temporary regulation of short selling, the FSMA requested market participants to refrain from lending the shares of the protected financial instruments. As covered short selling in Belgium was completely restricted and only subject to a disclosure requirement, the FSMA wished to keep covered short selling at least a bit under control by this request, which was supposed to make it more difficult for short sellers to find a shareholder willing to loan the shares they wanted to sell short. There are no studies available indicating the impact of this request and how willing large shareholders such as banks or insurance companies were to comply with it. We hypothesise however that, already having been helped by its measures against short selling and potentially in need of further financial help from the FSMA, financial institutions had plenty of incentives for complying with the FSMA’s request. Although it is only soft law, the effectiveness of this request should not be underestimated.

In the UK such a request would have been useless. Because covered short selling was already restricted in the sense that it could not lead to a net short position, the FCA did not need to further restrict it. However, the FCA asked financial institutions for help in detecting infringements of the short sale prohibition by requesting them to report any stock loans that they suspected to be intended for the creation of a net short position. Whether stock lenders followed up on this request is not known.

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140 We have addressed this earlier under title II, subtitle 1, chapter 3: “Naked short selling”, on page 22.
Subtitle 4. Scope of the regulation

Chapter 1. Protected stocks

Section 1. Stocks protected by the prohibition

The short sale prohibitions in the UK and Belgium were restricted to stocks of financial institutions publicly listed on the domestic market.\textsuperscript{143} Even though the Belgian regulator made clear in the Royal Decree of 23 September 2008 that the naked short selling prohibition only applied to naked short selling of shares of issuers of the financial sector, of which the shares or share certificates are admitted to trading on a Belgian regulated market, an annex to this Royal Decree, the regulator issued a list of the companies protected by the prohibition. This list contained only five companies: Dexia SA, Fortis NV/SA, ING Group NV, KBC Ancora SCA and KBC Group NV. On 22 September 2009, ING Group NV was removed from the list.\textsuperscript{144} Given the fact that a list of protected companies was included in the regulation itself and the small number of financial institutions publicly listed in Belgium, there was no confusion concerning the scope of the Belgian short sale prohibition. In the Royal Decree, the FSMA justified the scope of the prohibition by pointing out the importance of investor confidence for the health of financial sector companies.

In the UK, where the prohibition applied to “UK financial sector companies”, it was less clear which companies were or were not protected by the prohibition. In the Glossary of definitions in the Financial Conduct Authority Handbook, the FCA defined a “UK financial sector company” as a company that is a UK bank, a UK insurer or a UK incorporated parent undertaking of a UK bank or a UK insurer.\textsuperscript{145} Unlike the Belgian Royal Decree, the UK regulatory texts did not include a list of companies. On 19 September 2008, the FCA published a list of 29 UK financial institutions protected by the prohibition on her website, in an attempt to clarify matters for investors. This was not a success however, as the list contained several errors, such as the inclusion of the insurance company Resolution PLC, which had already

\begin{footnotesize}
\begin{enumerate}
\item Article 2, § 1, 1° of the Royal Decree of 23 September 2008; FSA 2008/50, “Short Selling (No 2) Instrument 2008”; points (a) and (b) of section 1.9.2C(1) of the Code of Market Conduct.
\item The reason why ING Group NV was removed from this list can be found under title IV, subtitle 1: “Inconsistency among national short selling regulations”, on page 71.
\item FSA 2008/50, “Short Selling (No 2) Instrument 2008”
\end{enumerate}
\end{footnotesize}
ceased to be listed in May 2008. Because of this, the FCA made some changes to the list, which ultimately included 32 stocks. The FCA’s list of companies protected by the prohibition was not binding. The list only amounted to an interpretation of the new regulation.

Considering the costs of short selling restrictions to the economy, we disapprove of the scopes of the prohibitions of short selling installed in Belgium and in the UK. The fact that the prohibitions apply to all financial institutions proves that the competent authorities did not investigate the necessity of protection from short selling separately for each financial institution, which is essential according to the theory concerning predatory short selling by BOEHMER and WU. When presenting their theory, which is one of the very few economic theories that actually supports short sale constraints in some cases, the authors stressed the importance of carefully comparing the benefits of such constraints with their costs for each individual company, as only vulnerable companies would benefit from a restriction on short selling. Neither the FSMA nor the FCA limited itself to prohibiting short selling of those financial institutions vulnerable for predatory short selling. Instead, they banned short selling of all national financial institutions, which is excessive at best or careless at worst.

The FCA on the other hand saw a form of constraint in the scope of its short selling prohibition, as it was restricted to financial stocks. One of the reasons the FCA gave for the exclusive protection of financial institutions is that financial sector companies, the existence of which depends on the confidence of their customers and counterparties in their stability, may be particularly susceptible to abusive short selling. In hindsight, the FCA’s worries seem to have been unjustified. After an attempt to identify justifications for the protection of financial stocks from short selling, MARSH and PAYNE concluded that there was no reason why financial stocks should have been protected any more than non-financial stocks. After thorough research, they stated that it was unclear to them why the FCA deemed it necessary to intervene

149 The fact that in Belgium only five companies were protected by the naked short selling ban should not lead to the conclusion that the Belgian government was more careful in setting the scope of its prohibition. Neither should the removal of ING Group NV from the list of protected companies, which, as we will later demonstrate, was done for other reasons than caution by the regulator.
specifically to change the nature of trading in the equities of financial sector stocks.\textsuperscript{152} An alternative explanation is that while the Belgian and UK governments felt the need to give the public the appearance of providing solutions for the financial crisis, they suspected that a total short selling ban would have heavily damaged the economy. Therefore, they might have limited the ban to the sector that was most stricken by the crisis and found itself in the centre of public attention.

Section 2. Stocks protected by the disclosure rule

The UK disclosure rule introduced in June 2008\textsuperscript{153} only applied to short selling transactions of securities which were the subject of a rights issue executed during the rights issue period, the latter being the period between the date of announcement of a rights issue and the date of the admittance of the shares on the market. The UK disclosure rule of June 2008 therefore only protected companies that were in the process of raising capital and therefore often already vulnerable.

Just like the abovementioned rule, the UK disclosure rule introduced in September 2008\textsuperscript{154} was intended to protect particularly vulnerable companies. This time, however, the regulator considered a far greater number of companies to be in a position of vulnerability, as the new disclosure rule was intended to protect all "UK financial sector companies"\textsuperscript{155}. The scope of the disclosure rule of September 2008 was therefore the same as the scope of the prohibition rule introduced on the same day.

The Belgian disclosure rule, introduced in the Royal Decree of 23 September 2008, applied to the same companies as the prohibition introduced in the same decree, namely issuers of the financial sector, of which the shares or share certificates were admitted to trading on a Belgian regulated market. The list of financial institutions added to this Royal Decree also applied to the disclosure rule.

\textsuperscript{153} FSA 2008/30, “Short Selling Instrument 2008”.
\textsuperscript{154} FSA 2008/50, “Short Selling (No 2) Instrument 2008”
\textsuperscript{155} FSA 2008/50, “Short Selling (No 2) Instrument 2008”
Section 3. Exemption for transactions entered into after the regulation

Both the Belgian and the UK regulator specifically exempted transactions entered into or orders placed before the regulations’ entry into force, respectively 22 and 19 September 2008.\textsuperscript{156}

Chapter 2. Persons subjected by the regulation

Section 1. Persons subjected

1. Short sellers

Article 25, § 1 of the Law of 2 August 2002 states that it is forbidden for \textit{anyone} to engage in the different types of market abuse. This means that in Belgium companies as well as private individuals were forbidden to sell stocks of the protected companies short without coverage. In the UK, the short selling ban also applied to \textit{anyone}. Section 118(1) of the Financial Services and Markets Act states that market abuse can be committed “by one person alone or by two or more persons jointly or in concert”. The Glossary of the Financial Conduct Authority Handbook defines the term “person” as “\textit{any person, including a body of persons corporate or unincorporated (that is, a natural person, a legal person and, for example, a partnership)}”.

2. Financial intermediaries

Article 2, 2\textdegree{} of the Royal Decree of 23 September 2008 also prohibited the cooperation of financial intermediaries in these transactions. According to this article, the intermediary was guilty of such cooperation if, before executing a transaction, he failed to take reasonable measures in order to verify whether this transaction was fully covered.

In the UK, there was no need for the FCA to write such a provision. Article 123(1) of the Financial Services and Markets Act gave the FCA the authority to not only sanction a person who has engaged in market abuse\textsuperscript{157}, but also anyone who has required or encouraged another person to engage in behaviour that amounts to market abuse, either by taking or by refraining from taking action\textsuperscript{158}. On the basis of this provision, financial intermediaries were prohibited

\textsuperscript{156} Section 1.9.2C(3) of the Code of Market Conduct; FSA 2008/50, “Short Selling (No 2) Instrument 2008”; article 2, § 3 of the Royal Decree of 23 September 2008.
\textsuperscript{157} Point (a) of section 123(1) of the Financial Services and Markets Act.
\textsuperscript{158} Point (b) of section 123(1) of the Financial Services and Markets Act.
from intentionally cooperating in the execution of short selling transactions, as this could be considered as encouragement in the sense of article 123(1)(b).

Furthermore, the Supervision Sourcebook of the Financial Conduct Authority Handbook (SUP) already provided regulation for financial intermediaries. SUP 15.10.2 states the following:

“A firm which arranges or executes a transaction with or for a client and which has reasonable grounds to suspect that the transaction might constitute market abuse must notify the FCA without delay.”

Read in conjunction with the regulation on short selling, which equates short selling with market abuse, SUP 15.10.2 requires financial intermediaries to report any transactions of which they have reasonable grounds to suspect they may amount to short selling. Annex 5 to SUP 15 provides a non-exhaustive list of indications of possible suspicious transactions financial intermediaries have to take into account.

**Section 2. The market maker exemption**

In article 2, § 2, of the Royal Decree of 23 September 2008, the regulator exempted market makers and liquidity providers from the naked short selling prohibition. Thereby, it followed the example of the other European countries. Article 2, § 2 emphasises however that this exemption only applies to those transactions necessary for the fulfilment of their obligations or hedging purposes.

The FCA’s Code of Market Conduct provided a similar exemption to the prohibition. Article 1.9.2C (2) stated that the prohibition did not apply to a person acting in the capacity of a market maker. Specifically for this provision, the FCA provide the following definition of a market maker:

“A market maker is an entity that, ordinarily as part of their business, deals as principal in equities, options or derivatives (whether OTC or exchange-traded):

a) to fulfil orders received from clients, in response to a client’s request to trade or to hedge positions arising out of those dealings; and/or
b) in a way that ordinarily has the effect of providing liquidity on a regular basis to the market on both bid and offer sides of the market in comparable size. Trading in circumstances other than genuinely for the provision of liquidity is not exempt.”

The FCA also clarified that the exemption only covered market makers when they were acting in that capacity.

In most aspects, the disclosure requirement in the UK and Belgium were the same. However, with regard to market makers, there was an important difference. In the Glossary of definitions, the FCA determined that in calculating whether a holder has a disclosable short position, the holder should not take into account any interest which he holds as a market maker in that capacity. In other words, market makers were exempted from the UK disclosure rules as long as they acted in that capacity. In Belgium, market makers were not exempted from the disclosure requirement. The exemption for market makers included in article 2, § 2 of the Royal Decree of 23 September 2008 only applies to the prohibition of naked short selling, not to the disclosure requirement.

The abovementioned exemptions are made in order not to impair the supply of liquidity too heavily. Market makers do not have an infinite supply of securities in their inventories. Often, a client orders a stock of which the market maker’s inventory is exhausted. In this case, the market maker has to sell this stock short in order to meet the client’s demand. In this case, the market maker normally will quickly buy back the shares he sold, as it not his intention to hold large positions for a long period of time.

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Subtitle 5. The legal framework of the regulations

In both Belgium and the UK, the binding nature of the short selling prohibitions was questionable. Both prohibitions were put into effect through regulation on market abuse. As we have already mentioned, both the Belgian Law of 2 August 2002 and the UK Financial Services and Markets Act contain a list of forbidden activities that amount to market abuse. Neither of these lists are exhaustive however, as the UK and Belgian legislator give the FCA and the government respectively the authority to determine other forbidden activities.

Chapter 1. The legal framework of the Belgian short selling measures

Article 25, § 1, 5° of the Law of 2 August 2002 states it is forbidden to: “engage in other activities, determined by the King, advised by the [CBFA], which impair or distort the smooth operation, the integrity and the transparency of the market or are likely to do so”\(^{164}\). There are two ways of interpreting this provision. According to a literal reading of this article, it is only forbidden to engage in activities determined by Royal Decree if these activities also impair or distort the smooth operation, the integrity and the transparency of the market or are likely to do so. This means that the activities that according to the Royal Decree amount to market abuse are only prohibited if the supervisor can prove the (potential) distortion of the integrity and transparency of the market. This will be particularly hard for the supervisor, given the proven beneficial effects of short selling on the market.\(^ {165}\) It is clear that a literal interpretation of the short selling prohibition heavily compromises the effectiveness of the short selling prohibition.

Article 25, § 1, 5° of the Law of 2 August 2002 can also be read as a limitation of the King’s authority. In this case, the King is authorised to determine that an activity amounts to market abuse only if this activity (potentially) distorts the integrity and transparency of the market. Once determined by the King, the supervisor does not have to prove that each individual breach of this provision did in fact lead to such a (potential) distortion. Since according to this interpretation the King is not authorised to prohibit activities that do not lead or are likely to

\(^{164}\) This citation was translated from Dutch and French. Original Dutch text: “andere handelingen te stellen, bepaald door de Koning op advies van de (CBFA), die de goede werking, de integriteit en de transparantie van de markt belemmeren of verstoren of dit kunnen doen”. Original French text: “de commettre d’autres actes, définis par le Roi sur avis de la (FSMA), qui entravent ou perturbent ou sont susceptible d’entraver ou de perturber le bon fonctionnement, l’intégrité et la transparence du marché”.
lead to such distortions, it can be argued that the King exceeded his authority, which would make the short selling prohibition void.\textsuperscript{166}

**Chapter 2. The legal framework of the UK short selling measures**

In the UK, article 119(1) of the Financial Services and Markets Act authorises the FCA to prepare and issue a code that gives guidance to those determining whether or not behaviour amounts to market abuse. Article 119(2) states that \textit{“the code may among other things specify descriptions of behaviour that, in the opinion of the Authority, amounts to market abuse”}. It is clear that this article does not give the FCA the authority to prohibit certain activities. In fact, it only serves as guidance for determining whether an activity such as short selling constitutes market abuse. Therefore, even though they may have had a certain persuasive value in Court, the short selling prohibition determined in article 1.9.2C of the Code of Market Conduct was not binding. This meant that, strictly speaking, it was still possible for an investor to sell shares of UK financial institutions short. When doing so, if the investor’s behaviour does not fall within the statutory definition of market abuse, he simply is not guilty of such.\textsuperscript{167}

Therefore, in order to determine the binding nature of the UK prohibition, one must determine whether short selling falls within the definition of market abuse. Article 118 of the Financial Services and Markets Act describes seven types of market abuse. Article 118(5)(a) qualifies the following activity as market abuse:

\textit{“behaviour [that] consists of effecting transactions or orders to trade (otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market) which [gives], or [is] likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more qualifying investments.”}

It is clear that not always when a net short position is taken, doing so will give, or will be likely to give, such a false or misleading impression. In fact, as we have argued before,\textsuperscript{168} there is little reason to assume that taking on a short position has more influence on other investors than

\textsuperscript{166} F. BOGAERT, “The Prohibition of Short Selling. The Belgian Regulation and European Developments”, 


\textsuperscript{168} Title II, subtitle 1, chapter 2, section 1: “Market manipulation”, page 19.
taking on a long position. When it does not lead to a false or misleading impression being given, taking on a net short position will be in line with the law, and therefore not prohibited.\textsuperscript{169}

\textbf{Chapter 3. Explanation for unfortunate choice of framework}

The FCA seems to have taken a somewhat unfortunate choice by choosing the legal framework of art. 119(2) of the Financial Services and Markets Act for the creation of its ban on short selling. However, with the government not being able to rely on the power to do so, it may have been the FCA’s only option. According to WILLMOTT and JAMES, two alternative ways of banning short selling would have been to either amend the statutory definition of market abuse or introduce new rules into the FCA Handbook. However, the authors claim that both ways were unfeasible at the time. The Financial Services and Markets Act, and therefore also the included statutory definition of market abuse, is primary legislation, which can only be amended by Parliament. Given the perceived urgency of the implementation of the ban, this would have taken too much time, especially considering that Parliament did not sit during mid-September. The introduction of new rules into the FCA Handbook was not a feasible option either, because these rules would only have applied to firms authorised by the FCA, whereas the FCA wanted the prohibition of short selling to apply to all investors.\textsuperscript{170}

Just like in the UK, the Belgian government, given the urgency of the measures, had no alternative than to install its prohibition on short selling within the legal framework of the regulation of market abuse.\textsuperscript{171}

Although legally questionable, both the UK and the Belgian governments seemed to have made the right decision by using the regulation of market abuse to introduce a short selling prohibition. The legal problems concerning their binding nature did not prevent the short selling bans from being successful. The media did not pay attention to the essentially non-binding


nature of the new provisions and portrayed them as nothing less than a short selling prohibition.172,173

Chapter 4. The amendment of the Financial Services and Markets Act 2000

Taking into account the theoretical problems concerning the binding nature of these measures, the UK legislator learned a valuable lesson. In order to intervene swiftly in case of a future financial crisis, the government was in need of a legal framework within which they could prohibit short selling for exceptional reasons. Therefore, on 8 June 2010, the UK legislator provided such a framework by adding Part 8A (articles 131B to 131K) to the Financial Services and Markets Act 2000.174

The new provisions on short selling in the Financial Services and Markets Act 2000 allow the FCA in specified cases to install both prohibitions on short selling of financial instruments175 and disclosure rules for short sellers.176

This new regulatory framework soon became useless, as shortly after its entry into force, the European Union introduced a similar framework for competent authorities such as the UK FCA. The provisions concerning the penalties for violations of the short selling regulations stayed relevant, however, as they now apply to violations of the European short selling regulation.

174 Part 8A was inserted by section 26(2)(8) of the Financial Services Act 2010.
175 Section 131B(1) of the Financial Services and Markets Act 2000.
176 Section 131B(2) of the Financial Services and Markets Act 2000.
Subtitle 6. Sanctioning

Chapter 1. The sanctioning regime in Belgium

In Belgium, the FSMA could sanction violations of the short selling measures in several ways. An investor who engaged in naked short selling or refrained from reporting a **disclosable** net short position, and therefore violated article 25, §1, 5° of the Law of 2 August, was guilty of market abuse. The sanctioning of market abuse in the sense of article 25 of this law is regulated in article 36 and 39 of the same law.

In case of a violation of the short selling measures, article 36, § 1 of the Law of 2 August 2002 stipulates that the FSMA could first command the offender to comply with the short selling regulation within a certain period of time set by the FSMA. Based on this provision, in case of a violation of the naked short selling ban, the FSMA could set a term for an investor to cover his short position in a financial sector stock, for example by entering into a securities lending agreement. If an investor refrains from reporting a net short position in breach of the disclosure rules, the FSMA could set a term in which the investor can eventually disclose his short position.\(^{177}\)

If the offender fails to comply within the term set by the FSMA, the latter can publish its position regarding the infringement\(^ {178}\) and impose a non-compliance penalty\(^ {179}\). This penalty cannot be lower than € 250 or higher than € 50.000 per day, or higher than € 2.500.000 in total. Furthermore, the FSMA can impose an administrative fine of anywhere between € 2.500 and € 2.500.000. If the offender made a profit from the violation, the maximum fine increases to double the profit he made and in case of a repeat offense, the maximum fine is triple this amount.\(^ {180}\) In a Q&A the FSMA indicated that in response to violations of the new short selling measures, it would in fact utilise its authority of article 36, § 2 of the Law of 2 August 2002 and impose administrative fines.\(^ {181}\)

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\(^{177}\) Article 36, § 1 of the Law of 2 August 2002.

\(^{178}\) Article 36, § 1, 1° of the Law of 2 August 2002.

\(^{179}\) Article 36, § 1, 2° of the Law of 2 August 2002.

\(^{180}\) Article 36, § 2 of the Law of 2 August 2002.

Besides administrative sanctions, a violation of the short selling measures could also lead to criminal sanctions. Article 39, § 1, 2° of the Law of 2 August 2002 states that anyone who executed a transaction that abnormally or artificially influenced or could influence market activity or the price or volume of a financial instrument could be punished with imprisonment for one month to two years and a fine of € 300 to € 10.000.

**Chapter 2. The sanctioning regime in the UK**

In the UK, the violation of the short selling measures amounted to market abuse in the sense of article 118 of the Financial Services and Markets Act. The sanctioning of such market abuse is regulated by article 123 of this act, according to which the FCA has two ways of sanctioning a violator. First of all, if the FCA can impose a fine. Whereas the Belgian legislator considerably restricts the authority of the supervisor in the setting of the fine by establishing a minimum and maximum amount, the UK legislator does no such thing. Instead, the Financial Services and Markets Act stipulates that the FCA may impose a fine of such amount as it considers appropriate. The FCA’s authority here is not limitless however, as the legislator among other things obligates the FCA to consider the following factors when determining the amount of the penalty:

- the effect of the violation on the market;
- the extent to which the violation was deliberate or reckless.

The UK legislator required the FCA to mainly regulate itself concerning the setting of the fines by obligating it to publish a statement of its policy with respect to the imposition and the amount of the penalty. In the Decision Procedure and Penalties Manual in the Financial Conduct Authority Handbook, the FCA did so by establishing a non-exhaustive list of criteria it will consider when setting a fine, including the two abovementioned criteria determined by the legislator. Because the FCA did not determine one, there is no maximum fine.

The FCA may also impose such a penalty to anyone who has required or encouraged another person or persons to engage in behaviour which amounts to market abuse. This way, the FCA

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182 Section 123(1)(a) of the Financial Services and Markets Act.
183 Section 124(2)(a) and (b) of the Financial Services and Markets Act.
184 Section 124(1)(a) and (b) of the Financial Services and Markets Act.
187 Section 123(1)(b) of the Financial Services and Markets Act.
can also sanction financial intermediaries who help investors in the execution of forbidden short selling activities. The Belgian regulation on the sanctioning of market abuse does not include a similar provision. This is not necessary for the sanctioning of financial intermediaries with regard to short selling however, as article 2, 2° of the Royal Decree of 23 September 2008 qualifies the cooperation by financial intermediaries in prohibited short selling transactions as market abuse.

Instead of imposing a fine on the offender, the FCA may also publish a statement to the effect that he has engaged in market abuse. This statement is called a *public censure*. Among others, the following considerations may be relevant for the FCA in order to choose for this sanction instead of the imposition of a fine:

- the level of deterrence achieved by the public censure;
- the (lack of) profit the violator made from the breach;
- the severity of the violation;
- cooperation by the violator with the FCA;
- the disciplinary record of the violator.

When the FCA proposes to take action regarding a case of market abuse, by imposing a fine or publishing the aforementioned statement, the FCA must first give the offender a warning notice. This notice must state the amount of the proposed penalty or set out the terms of the proposed statement. If the FCA ultimately decides to take action, it must give the offender a decision notice, which again states the amount of the proposed penalty or sets out the terms of the proposed statement.

The amendment of the Financial Services and Markets Act 2000 in 2010 changed the sanctioning regime in the UK. This sanctioning regime will be analysed later, when we address the sanctioning of the European short selling regulation in the UK.

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190 Section 126(1) of the Financial Services and Markets Act.

191 Section 126(2) and (3) of the Financial Services and Markets Act.

192 Section 127(1), (2) and (3) of the Financial Services and Markets Act.

193 Title IV, subtitle 2, section 3, subsection 3: “Sanctioning in the UK”, page 106 et seq.
Subtitle 7. Regulation after the expiration of the initial temporary measures

The Royal Decree of 23 September 2008, which was published in the *Belgian Official Journal* on 25 September 2008 entered into force on 22 September 2008. The decree’s retroactivity did not cause any problems however, as its content had already been made public in the announcement by the FSMA on 19 September 2008. Initially, the Royal Decree was a temporary measure as it was only effective until 21 December 2008. The rule got extended several times, however, until the Royal Decree of 22 September 2009 ultimately made the existing regulation permanent. The Belgian government did so in attendance of a unified European regulation. Given the fact that, in its annual report of 2008, the FSMA had expressed its intention to lift the short selling ban, this was a surprising move by the Belgian government.

The UK prohibition on the other hand was rather short-lived. Published on 18 September 2008 and entered into force a day later, the prohibition was determined to cease to have effect on 16 January 2009. Unlike the Belgian one, the UK prohibition was not extended. Instead, on its expiration date, the FCA deleted the text of the measure from the Code of Market Conduct. The FCA felt there was no need for the prohibition anymore because it believed the circumstances that led to the introduction of the prohibition had changed and the risks that caused it the greatest concern had eased. According to the FCA, a permanent ban on short selling would have been disproportionate considering the legitimate and beneficial market function of short selling. In addition, the FCA believed there was a risk a permanent prohibition restricted to a particular sector could result in displacement of short selling to other sectors.

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194 “Belgian Official Journal” is a translation from Dutch or French. The original titles are “Belgisch Staatsblad” or “Moniteur Belge”.
196 The Royal Decree of 23 September 2008 was extended by the Ministerial Decree of 19 December 2008, the Ministerial Decree of 17 March 2009, the Ministerial Decree of 18 May 2009 and ultimately made permanent by the Royal Decree of 22 September 2009.
197 The Royal Decree of 22 September 2009, which made the prohibition permanent, made one adaptation to the existing regulation: article 2 of the Royal Decree excluded ING NV from the list of protected financial institutions, which remained unchanged for the remainder.
199 FSA 2009/1, “Short selling (No 5) instrument 2009”.
The UK disclosure requirement on the other hand stayed in place after 18 September 2008, albeit slightly altered.
Subtitle 8. Regulatory changes following the fall of the stock markets in August 2011

Following the US’ credit rating downgrade and fear of the European debt crisis, Monday, 8 August 2011, also known as Black Monday, was characterized by heavily declining stock prices of companies all over the world, especially those of financial institutions.201 A few days later, several European countries202 introduced stricter short selling restrictions.203

On 11 August 2011, the Belgian FSMA announced a change in the regulation of short selling. From 12 August 2011 on, the prohibition, which previously only applied to naked short selling, also applied to covered short selling. The FSMA did so by giving a new interpretation to the term “coverage”. By determining that “coverage” referred only to the ownership of the sold securities by the seller, the FSMA also prohibited covered short selling.204,205

On 12 February 2012, the FSMA lifted the ban on short selling again.206 Instead, they introduced the locate rule in the sense of the European regulation on short selling, which was already published but only expected to come into effect on 1 November of that year. In short, the locate rule requires short sellers who have not borrowed the relevant shares to make arrangements with a third party in order to ensure that settlement of the sale can take place when due. This will later be explained more thoroughly.207

In the UK, where the prohibition of short selling in any form had already been lifted, the FCA decided not to re-install a new short sale restriction. An FCA spokeswoman stated: “we have an existing short selling disclosure regime around financial stocks in place and we continue to monitor the activity in our markets accordingly. We have no current plans to introduce a short-

202 These countries were Belgium, France, Greece, Italy and Spain.
207 Title IV, subtitle 2, chapter 3, section 1, subsection 1, point 3.2: “Coverage by arrangements with third parties: the locate rule”, page 81 et seq.
The new short selling ban in Belgium came at a time when research started pointing at the costs of short selling restrictions. Within the FCA, which realised that the emergency measures against short selling in 2008 probably caused more damage than it helped the economy, there was much scepticism concerning bans on short selling. It is surprising to us that such scepticism did not exist within the Belgian FSMA.

Yet, on 12 August 2011, the ban led to a significant increase of share prices of banks. The share price of the Belgian bank Dexia even increased by 14%. On the long term, however, the effects of the ban are likely to have been be less positive.

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Subtitle 9. Evaluation of the short selling measures

Evaluating the ban on short selling in the U.S., Christopher Cox, chairman of the U.S. Securities and Exchange Commission from 2005 to 2009, famously stated the following in an interview:

“[...] knowing what we know now, I believe on balance the commission would not do it again. The costs [of the short selling ban on financial sector stocks] appear to outweigh the benefits.” ²¹²

With regard to the short selling prohibition in Belgium and the UK, if we consider the empirical research on the effects of the short selling prohibitions,²¹³ we come to a similar conclusion: the costs seem to have outweighed the benefits.

In this chapter, we will thoroughly evaluate the short selling measures introduced in Belgium and the UK during the financial crisis. We will begin this evaluation by analysing the legitimacy of the objectives put forward by the government of these countries. Subsequently, we will address the effects of the regulations on investors and on the economy as a whole. Afterwards, we will propose alternative approaches the governments concerned could have taken when imposing the measures against short selling, taking into account the objectives they had set forward. A possible explanation will be presented for what we consider to be a failed intervention, and, finally, we will offer an explanation for the difference in duration between the short selling prohibitions in Belgium and the UK.

Chapter 1. Objectives of the short selling measures

In evaluating the UK and Belgian prohibitions on short selling, we must keep into account the objectives the respective regulators set forward. The Belgian FSMA claimed that the short selling measures were in particular aimed at the prevention of abusive short selling. The UK FCA shared the FSMA’s concern for abusive short selling and also stated it as the main reason

for its short selling prohibition. In our opinion, this makes little sense. To us, the prohibition of a legitimate investment practice in order to prevent practices that already are prohibited is clearly excessive, especially considering the many alternative ways of sanctioning abusive short selling.

On the other hand, a short selling ban may have been easier for the supervisory authorities to execute. Using the regular market abuse regulations as a means for sanctioning abusive short selling may have been difficult because doing so would have required the supervisory authorities to prove the abusiveness of each individual short sale transaction. Taking into account the many benefits of short selling, this would prove to be very difficult in most cases. In fact, during the crisis, there were no known short sellers in Belgium or the UK who actually spread false rumours about financial institutions or acted in concert with others to intentionally create a downward spiral of the price of a financial sector stock. We therefore expect that the application of the regular market abuse regulation would not have brought much change to the financial markets. However, given the fact that no such clear abuse occurred, we believe that, despite the supervisory authorities’ claims, the main reason for the prohibition of short selling was not the allegedly pressing problem of abusive short selling.

The FSMA and FCA also claimed that the short selling measures more generally were meant to protect the integrity, stability and quality of the financial market. In its press release announcing the short selling measures, the FCA focused on the extreme market conditions at that time. Even though it believed short selling to be a legitimate investment technique, the FCA believed extreme circumstances had led to disorderly markets, a situation which could be aggravated by short sellers. This justification for the prohibition of short selling makes more sense, as it at least logically explains the necessity of a prohibition of short selling. Empirical research has proven, however, that the prohibition on short selling did not have the intended effects and many have questioned whether the prohibitions were really necessary.

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218 See footnote 208.
Another possible reason why governments introduced measures against short selling, besides the alleged amount of abusive short selling activities, could simply be the fact that governments intended to stop the prices of financial sector stocks from decreasing. While vast numbers of people were losing money, governments could not just do nothing, even though that may have been their best course of action. Above all, governments wanted to drive up the prices of financial sector stocks. With CEOs of financial institutions pointing at short sellers as the cause of the downfall of so many companies and the outrage among many people towards investors gaining money from other people’s misfortune, it was only a small step for governments all over Europe to constrain these supposed culprits. Especially considering the fact that short sellers do drive stock prices down, whether legitimately or not, this seemed like an easy decision for regulators.

Chapter 2. Effects of the regulations on investors

The selection of one of the three different types of short sale prohibitions by the regulator of a certain country, has consequences for investors in this country and its economy as a whole. In this section we will analyse how different types of short selling prohibitions in the UK and in Belgium affected investors. We will make a distinction between investors who engage in short selling for hedging reasons and investor who do so for speculative reasons, because both are completely differently affected by the short selling prohibitions.

1. Effects on hedging

There is a reason why neither Belgium nor the UK did not create a complete ban on taking on a short position in a company. Both short selling restrictions were modified in a way that the creation of a short position for hedging purposes was still possible. Rightfully so, as hedging is an essential means for risk management. Through hedging, an investor can temporary limit his exposure to a certain security in which he has a long position. An investor usually does so by trading in derivatives, since short selling in its classic form would make little sense. An investor

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219 In 2008, for example, in a famous memo to his employees, John Mack, the CEO of Morgan Stanley, wrote: “short sellers are driving [our] stock down.” (B. SAPORT®, “Are Short Sellers to Blame for the Financial Crisis?”, *Time*, [http://content.time.com/time/business/article/0,8599,1842499,00.html](http://content.time.com/time/business/article/0,8599,1842499,00.html), 18 September 2008.)

220 We use the term “speculative purpose” here to refer to short sellers who wish to make a profit from short selling, as opposed to short sellers with a hedging purpose.

221 Note that, with the term “short position”, we do not refer to “net short position”. The creation of the latter has in fact been banned in several countries, such as in the UK.
who owns shares of a certain company, per definition cannot sell these shares short, since he already owns them. If an investor fears a temporary price drop of his shares, by buying put options on his own shares he can compensate the losses he suffers from such a price drop with the gains he makes from those put options. If the feared price drop does not occur, his put options will be worthless, but at least his shares did not decrease in value. Hedging can be expensive, but it is indispensable for a company that wants to manage its risk. By only banning naked short selling or trading in derivatives without coverage, the Belgian regulator did not touch hedgers. Owning the shares they take a short position in, they are automatically covered. The UK did not target hedgers either with its short selling regulation. By forbidding the creation of a net short position, the FCA allowed hedgers to create a short position in the protected financial institutions, as long as their long position was larger.

2. Effects on speculative short selling

Whereas the different approaches to the regulation of short selling had no impact on the respective situations of short sellers with hedging purposes in the UK and in Belgium, they did affect investors who engaged in short selling for speculative purposes. For Belgian and UK investors who did so, each approach led to a different situation. In the UK, where it was forbidden to create or increase a net short position in the protected financial institutions, short selling for speculative purposes was simply made impossible. In Belgium on the other hand, short selling for speculative purposes could still take place, as long as the short seller covered his short position. For short sellers wanting to make a profit from a price decrease of the shares of the protected financial institutions, the Belgian approach to the short selling prohibition in August 2008 was therefore far more beneficial.

On the other hand, the short selling prohibition in the UK only lasted for a few months, whereas the Belgian prohibition stayed in place for years. In fact, in 2011 the short selling prohibition was made even more strict, as the Belgian regulator also banned covered short selling. In this regard, the Belgian regulator was more averse to short sellers than the UK regulator.
Chapter 3. Effects of the regulations on the economy

1. Academic research on the effects of the short selling measures

Analysing the short selling prohibitions in the UK and in Belgium introduced in August 2008, we come to an important hypothesis. Considering the many benefits of short selling for the economy, such as the increase of price efficiency and the supply of liquidity, strict short selling regulation seems detrimental to the economy. Because in the UK, investors could not express their negative feelings concerning the protected financial institutions in any way, neither by covered or naked short selling nor by derivative transactions, the share prices of those institutions can be expected to have been distorted significantly. Taking into account the important role of short sellers in the supply liquidity, by completely banning short selling for speculative purposes, the UK regulation can also be expected to have had a detrimental effect on the liquidity of the protected shares, much more so than the impact Belgian regulation had. By still allowing covered short selling, the Belgian regulator seems to have been far more lenient towards short sellers with speculative purposes. Although heavily restricted, these short sellers were still able to express their negative opinions concerning the protected companies.

Given the damage short selling restrictions cause to the economy, we suspect that this damage is proportional to the severity of the restriction imposed. Therefore we hypothesise that, in comparison to the UK, regulation in Belgium should have had a less negative impact on the economy in terms of price efficiency and liquidity. At least until the UK lifted the ban. We emphasise, however, that the gravity of this difference should not be exaggerated since Belgian regulation still heavily restricted short selling. Not only were short sellers now obligated to cover their short sales, the cost of such coverage was also made more expensive because of the request by the FSMA to financial institutions not to lend shares of the protected institutions. Earlier we hypothesised that, even though the FSMA’s request was not binding, it might have had significant support among financial institutions. Because of this, we expect this request to have led to a significant decrease in the supply of the aforementioned shares available for borrowing. According to basic economics, this in turn should have led to greater borrowing costs for short sellers.

To test the abovementioned hypothesis, we analyse economic studies on the effects of short sale restrictions during the financial crisis. In a study on the effects of short sale restrictions all over the world, BEBER and PAGANO researched how these restrictions affected liquidity by
comparing the median bid-ask spread of the protected shares before the implementation of the restriction with the median bid-ask spread after the implementation.\footnote{A. BEBER and M. PAGANO, “Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis, Journal of Finance, vol. 68, no. 1, 2013, 358-359.} In all the eighteen countries that they analysed, the median bid-ask spread increased at an average of 127 % after the introduction of short sale restrictions.\footnote{The following countries were included in the study: Australia, Austria, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Portugal, South Korea, Spain, Switzerland and the United States.} All these short selling restrictions were installed at a time with a very unstable financial climate however, which could be an alternative explanation for the sudden decrease of liquidity in the markets. This concern was shared by the authors, who also calculated the median bid-ask spreads before and after the different short selling bans of shares of companies not protected by these bans.\footnote{The following countries installed a ban of short selling protecting all its domestic companies instead of just a selected number of financial institutions, and were therefore not included in this calculation: Australia, Italy, Japan, South Korea, Spain and Switzerland.} The median bid-ask spread of the shares of these unprotected companies only increased by 49 %. Compared to an increase of 127 % for the protected companies, we can assume that short sale restrictions in the countries included in the study have in fact affected liquidity negatively. To test our hypothesis that the prohibition of short selling in the UK had a greater impact on the economy than the Belgian prohibition, we compare the percentages at which the median bid-ask spreads of the protected companies’ stocks increased after the introduction of the prohibition of short selling in Belgium and in the UK. This comparison supports our hypothesis: the aforementioned median bid-ask spread in Belgium increased 88 % after the introduction of the prohibition, whereas in the UK the increase amounted to 223 %. The median bid-ask spread of unprotected stocks rose by 59 % in Belgium and by 73 % in the UK.

These outcomes should not be considered conclusive proof of our hypothesis, however. If we consider that at the time of introduction of the prohibition the median bid ask-spread for protected stocks went up from 0.2791 to 0.5239 % in Belgium and from 0.1429 to 0.4619 % in the UK we must nuance our position. Before the prohibition, the median bid-ask spread of protected stocks in Belgium was 0.2791%, almost double than that in the UK. Even after the prohibition, the median bid-ask spread in Belgium was still greater. These numbers could indicate that the role of short sellers in supplying liquidity of the protected stocks to the market is far greater in the UK than in Belgium, perhaps partially because short selling is more common in the UK market. If this is the case, it is only logical that the prohibition of short selling has a greater impact in UK than in Belgium. By that logic, the difference in percentage by which their
respective bid-ask spreads increased, tells us little about the difference in impact between the chosen approaches to prohibiting short selling in Belgium and the UK. Nevertheless, considering the magnitude of the difference between the percentages at which the median bid-ask spreads of the protected stocks increased, in this study, we see strong support for the hypothesis that the UK short sale prohibition had a more negative effect on the economy than the Belgian short sale prohibition.

This conclusion is supported by a study by MARSH and NIEMER on the impact of short selling restrictions on stock returns. The authors conclude that there is no evidence that restrictions on short selling in the UK or elsewhere changed the behaviour of stock returns.225

There are no studies available that allow us to draw conclusions on the difference in impact on price efficiency between the different types short sale constraints in the UK and those in Belgium. However, many studies on the impact of short sale constraints in the financial crisis of 2008 provide evidence supporting the theories of MILLER, DIAMOND and VERRECHIA, and BAI et al., verifying the impairment of price efficiency short sale constraints are said to cause.226 The results of research conducted by MARSH and PAYNE, in which the authors analysed price efficiency of financial stocks in the UK and compared them to non-financial stocks, were grim. According to these authors, the price efficiency of financial stocks deteriorated much more than the price efficiency of non-financial stocks. MARSH and PAYNE stress that the FCA did in no way achieve the objectives they put forward.227 Although we cannot make comparisons between the short sale constraints in the UK and in Belgium with regard to the effect of the respective short sale constraints on price efficiency, we can conclude that both are highly likely to have considerably impaired price efficiency.

If we assume our hypothesis to be true and the UK prohibition was in fact more detrimental to the economy, in the long term, the Belgian short selling regulation is far more likely to have affected the economy more negatively. This is because in early 2009, the FCA, referring to research that indicated the negative effects of such prohibitions, decided not to extend the UK short selling prohibition, whereas the Belgian prohibition was made permanent and eventually

even strengthened. In the short term the UK prohibition might have been worse for the markets, but the Belgian permanent short selling regulation is likely to have had a more long term effect.

2. Self-evaluation by the UK’s FCA and the lack thereof in Belgium

When analysing the impact of its short selling regulation, the FCA admitted there was no evidence that the short selling ban improved stock returns of financial sector stocks in the long term. When justifying its temporary short selling regulation, the FCA stated that at the time of installing the new regulation, it was mainly concerned with “the potential [of short sellers] to employ abusive short selling strategies, possibly on the back of false rumours and/or in concert with others, to drive down share prices”. After the expiration of the temporary ban on short selling of financial sector stocks, which was meant to prevent such strategies, the FCA decided not to extend it, as, according to the FCA, the economic climate had improved.

In relation to stock returns, the FCA initially saw benefits arising from its short selling regulation, as in the first 15 days after the introduction of the ban, the stock returns of the protected companies was better than those of the FTSE 350. In the long term however, the FCA noted that the ban on short selling did not significantly improve the stock returns of these companies. With regard to liquidity, the FCA states that bid-ask spreads have indeed increased considerably more for the protected stocks than for the market as a whole.

It is clear that the short selling ban in the UK was not a success, which is probably why the FCA did not renew the prohibition or introduced a new one; not even in August 2011, a time of severe financial instability.

In August 2011, Belgium was one of the countries that did install a new ban on short selling. More specifically, its government made the existing short selling ban more strict by not only prohibiting naked but also covered short selling. Yet, there was no evidence that the existing restrictions on short selling were in any way successful. Granted, there was also little evidence

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231 This conclusion is similar to the one made by MARSH and NIEMER. (I.W. MARSH and N. NIEMER, “The Impact of Short Sales Restrictions”, Independent analysis commissioned by the International Securities Lending Association (ISLA), the Alternative Investment Management Association (AIMA) and the London Investment Banking Association (LIBA), 2008, 24.)
pointing to the contrary. In fact, there was a remarkable lack of research on the impact of the Belgian short selling measures on the economy. In none of the annual reports by the FSMA did the latter conduct any type of empirical analysis. This lack of research on the effects of the measures on the Belgian economy makes it very difficult to evaluate the success or failure of the Belgian measures against short selling during the financial crisis; not only for us, but also for the Belgian government itself. Yet, the available information referred to in the previous subsection, indicates that the costs have outweighed the benefits.

Chapter 4. Alternatives for sanctioning abusive short selling

In its press release of 19 September 2008, the FSMA stated the short selling measures “[were], in particular, aimed at preventing the execution of transactions which give or are likely to give false or misleading signals regarding the supply of, demand for or price of financial instruments, as provided for in article 25 of the Law of 2 August 2002.”\(^{233}\) In a discussion paper, the FCA acknowledged the danger of these misleading signals and stated that financial sector companies, the existence of which depends on the confidence of customers and counterparties in their stability, may be particularly susceptible to such market manipulation, especially in a climate of severe market turbulence and uncertainty.

Taking into account the abovementioned objective of the short selling measures, we find the prohibition of short selling an excessive solution. As the FSMA indicated, article 25 of the Law of 2 August 2002 already served as a great means for tackling abusive sort selling. Article 25, 2°, a) of the Law of 2 August 2002 prohibits transactions or orders which give or are likely to give false or misleading signals regarding the supply of, demand for or price of financial instruments. In the UK, the Financial Services and Markets Act provided for a similar tool for sanctioning abusive short selling. Section 118(8) forbids any behaviour that is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for or price or value of a qualifying investment. These provisions already allow for the sanctioning of short selling that give or are likely to give false misleading signals as mentioned above. It seems excessive to install a ban on the short selling of financial sector stocks in order to prevent something that is already prohibited by law.

In case the aforementioned provisions do not apply, the Belgian and UK regulations on market abuse, respectively established in article 25 of the Law of 2 August 2002 and section 118 of the Financial Services and Markets Act, also contain other provisions that may be used against abusive short selling.

For starters, according to section 118(5)(b) of the Financial Services and Markets Act and article 25, 2°, b) of the Law of 2 August 2002, it is forbidden to drive up or drive down prices to an artificial or abnormal level by one or more persons acting in concert. These provisions form a perfect legal basis for the prohibition and sanctioning of bear raids.

Short selling is also often told to be accompanied by the spreading of false rumours. Here, section 118(7) and article 25, 4° of the same laws offer a solution, as they prohibit the spreading of information that (potentially) creates misleading signals about financial instruments by anyone who knew or should have known that the information was false or misleading. In Belgium, there is even a specific provision in article 25, § 4 for financial sector stocks that specifically prohibits the spreading of false rumours about the financial health of financial institutions that may damage the financial stability of this institution.

Chapter 5. Failed measures and Belgian persistence: an explanation

Previously, we have addressed the positive effects short selling restrictions have had on shares in the short term. In the UK, the short selling ban in 2008 had a positive effect on stock returns in the first 15 days. The same short term effect was documented in Belgium in August 2011, when share prices of banks increased greatly the day of the introduction of the new and stricter short selling ban. The share price of the Belgian bank Dexia even increased by 14%.

These short term results can be logically explained by two factors. First of all, the many misconceptions about short sellers being greedy forces of destruction, lead to heavy support of any restrictions on their activities. This may cause investors, whose trust in the markets has been strengthened by these restrictions, to invest in stocks again. Secondly, the short term results can be explained by the theory of MILLER, according to whom share prices rise following a restriction on short selling. Well informed investors, familiar with the theory of MILLER, may see the introduction of a short selling ban as a way to make a quick profit. Considering the theory of DIAMOND and VERRECCHIA, which states that price discovery is merely slowed down by short selling restrictions but does not rule out the possibility of a
temporary increase of share prices, these positive results following a short selling ban are only temporary.

In our opinion, these short term results are exactly why it is so appealing to governments to introduce short selling bans. Governments can rarely present voters results as positive as the ones they could present on 12 August 2011. The day the Belgian government issued further restrictions on the greedy forces of destruction that are short sellers, many shareholders saw their capital increase again, after months of losing money. And while the short term results of short selling bans are documented all over the media, there is far less attention for the long term effects of the measures by the government. With regard to the Belgian emergency measures, barely any research has been done on its impact on the economy.

This lack of research may have been the main cause of the difference in duration between the Belgian and the UK prohibition of short selling. Whereas the UK’s FCA published a thorough analysis of the impact of its short selling measures on the UK economy,234 the Belgian FSMA did not. In fact, in none of the annual reports it published during the period in which the Belgian (naked) short selling ban was in place, did the FSMA conduct empirical research on the effects of its regulation. This lack of self-evaluation is one of the reasons we believe the Belgian short sale restriction stayed in place for so long, even though many studies were available pointing out the dangers of such prohibitions.

In the future, we believe it is important for the competent authority to evaluate the effects of the measures it installs. Considering the negligence demonstrated by member states such as Belgium in relation to such self-evaluation, we believe the European regulation on short selling should contain a provision that requires the authorities that take emergency measures to thoroughly analyse the effects of these measures.

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Subtitle 1. Inconsistency among national short selling regulations

When announcing its measures against short selling, the FSMA stated they were “aimed at maintaining a consistent regulatory framework among the various financial markets”. As the FSMA indicated in this announcement, it acted in concert with the other supervisory authorities responsible for the supervision of Euronext, such as the FCA. As all over Europe short selling restrictions were being taken, it was hard for the Belgian FSMA to stay behind. Refraining to do so could move European short sellers’ focus on the Belgian financial institutions. Given the costs of fragmented regulation, the consistency of the regulatory framework of the European financial market is undeniably an important objective for any government. Unfortunately, the different national short selling regulations turned out to be anything but consistent.

The European Securities Markets Expert Group (ESME) explained in a paper called “Position on Short Selling” the necessity of internationally consistent regulations on short selling. Many major shares are listed on organised markets in different countries. Since national regulators can only supervise the organised markets in their own countries, the regulation of short selling with regard to the shares of one particular company may be heavily fragmented.

The situation of ING in Belgium and the Netherlands in 2009 is a perfect illustration of such fragmentation. On 1 June 2009, the ban on short selling in the Netherlands expired. From then on, short selling of financial institutions publicly listed on the Dutch stock exchange (Euronext Amsterdam) was allowed. As we know, this was not the case in Belgium, where naked short selling of financial institutions listed on the Belgian stock exchange (Euronext Brussels) was prohibited at that time. Among those latter financial institutions was ING Group NV, which was listed not only on Euronext Brussels but also on Euronext Amsterdam. The result of the inconsistency between the Dutch and Belgian short selling regulation was that short selling of shares of ING Group NV on Euronext Amsterdam was allowed, whereas doing so on Euronext Brussels was prohibited.

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Brussels was forbidden. This regulatory discrepancy made the Belgian short selling regulation with regard to ING shares completely useless and nothing more than a nuisance for investors, who simply had to turn to the Dutch market in order to sell ING shares short. Yet, this situation was not resolved until months later when the Belgian government deleted ING Group NV from the list of protected financial institutions in the Royal Decree of 22 September 2009.

The regulatory situation regarding ING shares was a nuisance for investors who had to be aware of the fact that short selling ING shares was possible in the Netherlands, but not in Belgium. This may not seem like a very difficult situation for those investors, but the fact is that there were a lot more regulatory discrepancies such as the one mentioned here. As mentioned before, there are many types of short selling prohibitions. Not only are there regulatory differences between countries, such as the difference between the Belgium and the UK short selling prohibition, but national regulations also evolve. In Italy, in 2008, the short selling prohibition initially only applied to naked short selling of financial sectors stocks, but was then extended to covered short selling as well. Later, the prohibition not only protected financial sector stocks anymore, but also all other stocks publicly listed on the Italian stock exchange. In 2009, the Italian short selling prohibition was restricted again to naked short selling, but only regarding nonfinancial stocks. Later however, the prohibition was also restricted to naked short selling of financial stocks. Complex as it may seem, this is only one example of the prohibition in one country. Short selling prohibitions in other countries underwent evolutions too, for example in Belgium. And then we have not even discussed all the different formalities of all the different national disclosure requirements. It is clear that large investors, which operate on a global level, had to incur great costs to get to learn all the different short selling regulations and keep up with all the evolutions those regulations went through. We can therefore assume that not only the separate regulations on short selling restricted short sellers, but also the discrepancies between them, therefore increasing the negative effects of short sale constraints, such as the decrease of liquidity and price efficiency. For these reasons, like the ESME\textsuperscript{237}, we believe it is imperative that short selling regulations are coordinated at a European or global level.

Subtitle 2. The European short selling regulation

Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (from here on called Regulation (EU) No 236/2012) was the European Union’s answer to the regulatory inconsistency concerning short selling regulation during the financial crisis. The European short selling regulation was twofold: it introduced a permanent disclosure requirement and a prohibition of naked short selling as well as a legal framework within which authorities of member states can take emergency measures against short selling. The permanent regulation applies to two types of short selling: the short selling of shares and the short selling of sovereign debt instruments such as sovereign debt obligations.

Chapter 1. Objectives of the regulation

Section 1. Regulatory consistency

The European Union intended to achieve regulatory consistency in two ways. As we have seen in previous chapters, during the crisis itself, member states regulated short selling in the most divergent ways. This, in the opinion of the EU regulator, was an obstacle to the proper functioning of the internal market. In order to prevent such divergence and ensure greater coordination and consistency between member states in case exceptional circumstances demand for measures against short selling, the EU believed a common regulatory framework concerning the requirements and powers relating to short selling was necessary.238

Not only regulation in Europe during the financial crisis was inconsistent, but also regulation after the crisis. In the aftermath of the financial crisis, many European countries had partially or completely kept the short selling regulation they introduced during the crisis. In the UK for example, even though the short selling prohibition was lifted quite soon, the disclosure rule remained in effect. In Belgium on the other hand, the disclosure rule as well as the short selling prohibition were made permanent. The financial crisis had left Europe with heavily fragmented short sale regulation, which, according to the EU, was an obstacle to the proper functioning of

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238 Point (2) of the preamble to Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps (Regulation (EU) No 236/2012).
the internal market. The European solution to this problem was the harmonisation of the regulation of short selling.

In other words, the EU intended to achieve permanent regulatory consistency as well as regulatory consistency in exceptional circumstances that demand for temporary emergency measures. In order to do the latter, the scope of the SSR had to be determined as broad as broad as possible. That way, in exceptional circumstances, the SSR could serve as a legal framework for the regulation of all types of financial securities.\textsuperscript{239}

**Section 2. Reduced risks of short selling**

In order to put an end to the regulatory inconsistency concerning the permanent regulation of short selling, the EU considered it necessary to address and limit the potential risks arising from short selling. Refraining from doing so, would again cause member states to take inevitably divergent measures. However, the EU expresses the need for caution concerning the limitation of the potential risks of short selling. Since short selling enhances the quality and efficiency of the market, it is important that any attempt to limit the costs of short selling does not unduly detract from these benefits.\textsuperscript{240} Achieving a good balance between those two elements is a difficult task.

Furthermore, in times of emergency, the European legislator believed member states needed to have clear powers to intervene in order to reduce systemic risks and risks to financial stability and market confidence caused by short selling.\textsuperscript{241} During the financial crisis, many countries had difficulties introducing emergency measures against short selling because there was no legal framework for doing so. Countries such as Belgium and the UK had to make use of legislation not designed to serve as a legal framework for the taking of emergency measures. In both cases, this could have led to a serious impediment of the binding nature of these measures. The European legislator wanted to prevent situations like this from happening again by providing member states with a legal framework within which they can take emergency measures in exceptional situations. In these types of situations however, the regulator also wished to ensure coordination between the member states and Europe.

\textsuperscript{239} Point (4) of the preamble to Regulation (EU) No 236/2012.
\textsuperscript{240} Point (5) of the preamble to Regulation (EU) No 236/2012.
Section 3. Enhanced transparency

During and after the financial crisis, the European regulator observed a lack of transparency in relation to short selling. According to the European Union, this lack of transparency prevented regulators from being able to detect at an early stage the development of short positions that may cause risks to financial stability or market integrity. According to the European regulator, enhanced transparency concerning net short positions in certain financial instruments is likely to be beneficial for regulators as well as market participants. The regulator intends to achieve such transparency by making private (i.e. the notification of the competent authority) and public disclosure of certain net short positions obligatory. The European short selling regulation contains disclosure requirements for short sellers. These requirements are believed to be beneficial for regulators, as they allow them to monitor and investigate short selling that could create system risks, be abusive or create disorderly markets. Market participants are said to profit from the disclosure rules because they provide them with useful information.

The above does not apply to the transparency concerning the short selling of sovereign debt however. The European regulator believes that, whereas the private disclosure of short positions in sovereign debt can benefit regulators in monitoring whether short selling activities may cause systemic risks or may be used for abusive purposes, the public disclosure of net short positions in sovereign debt could have a negative effect. The public disclosure of such positions could be detrimental as it constitutes a negative signal about a market that may already be struggling. In our opinion, however, the same could be said about the public disclosure of a net short position in a financial instrument.

Chapter 2. Scope of the regulation

In order to achieve full harmonisation and provide for a preventive regulatory framework to be used in exceptional circumstances, the European Parliament intended to make the scope of the Regulation as broad as possible. Article 1 of Regulation (EU) No 236/2012 determines the scope of the Regulation by referring to Directive 2004/39/EC, also known as MiFID 1. The European short selling regulation applies to all financial instruments, as listed in Section C of

243 Point (7) of the preamble to Regulation (EU) No 236/2012.
244 Point (8) of the preamble to Regulation (EU) No 236/2012.
245 Point (4) of the preamble to Regulation (EU) No 236/2012.
Annex I to MiFID 1\textsuperscript{246}, on the condition that they are admitted to trading on a trading venue\textsuperscript{247} in the European Union. Note that the only condition here is the admittance of the financial instrument on a trading venue. The European legislator makes it very clear that for those shares, the Regulation also applies if they are traded outside such a trading venue. Derivatives that are not admitted to trading on a trading venue but relate to a financial instrument that does fit the description above, also fall within the scope of Regulation (EU) No 236/2012. This also applies to debt instruments that are not admitted to trading on a trading venue but relate or are referenced to a debt instrument issued by a member state or the European Union.

The Regulation does not discriminate based on the person trading the abovementioned financial instruments. It is irrelevant where that person is domiciled or established.

**Chapter 3. The European permanent short selling regulation**

**Section 1. Provisions**

**Subsection 1. The prohibition of naked short selling**

Like the Belgian regulation during the financial crisis, the European regulator introduced a prohibition of naked short selling. The European short selling regulation prohibits two types of naked short selling: the naked short selling of shares\textsuperscript{248} and the naked short selling of sovereign debt\textsuperscript{249}. As the European regulator intended to still allow covered short selling, the European short selling regulation had to determine the different ways a short seller could cover his short sales.

**1. Objectives**

The European prohibition of naked short selling has two objectives: reducing the risk of settlement failures and reducing volatility.\textsuperscript{250} It is highly likely that the ban on naked short

\textsuperscript{246} Among others, this list contains transferable securities, money-market instruments, units in collective investment and derivatives.

\textsuperscript{247} Article 2(l) of Regulation (EU) No 236/2012 defines a trading venue as a regulated market within the meaning of article 4(1)(14) of Directive 2004/39/EC of 21 April 2004 on markets in financial instruments (MiFID 1) or a multilateral trading facility within the meaning of article 4(1)(15) of MiFID 1.

\textsuperscript{248} Article 12 of Regulation (EU) No 236/2012.

\textsuperscript{249} Article 13 of Regulation (EU) No 236/2012.

sellers will lead to a reduction of the amount of settlement failures. However, we doubt that the prohibition of naked short will reduce volatility. In a study on the effects of naked short selling, FOTAK, RAMAN and YADAV found that naked short selling significantly reduces volatility.\textsuperscript{251} Furthermore, research on the impact of short sale restrictions during the financial crisis 2008 has consistently shown that such restrictions lead to an increase of volatility.\textsuperscript{252}

2. The European definition of short selling

Article 2(1)(b) of Regulation (EU) No 236/2012 defines a short sale of a share or debt instrument as follows:

“any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement.”

The European legislator emphasised that covered short sales also fall inside the scope of Regulation (EU) No 236/2012.

The following transactions fall outside the scope of Regulation (EU) No 236/2012:

(i) a sale by either party under a repurchase agreement where one party has agreed to sell the other a security at a specified price with a commitment from the other party to sell the security back at a later date at another specified price;

(ii) a transfer of securities under a securities lending agreement; or

(iii) entry into a futures contract or other derivative contract where it is agreed to sell securities at a specified price at a future date.”\textsuperscript{253}

Given the prohibition of naked short selling, in order for a short sale, as defined above, to be in compliance with European regulation, it should be covered. In the section below, we will give an overview of the ways to which a short seller can do so.


\textsuperscript{253} Article 2(b), points (i) to (iii) of Regulation (EU) No 236/2012.
3. The coverage of short sales

Article 12, section 1 of the SSR determines that a natural or legal person may only sell shares short if one of the following three conditions are fulfilled, and the short sale therefore qualifies as a covered short sale:

a) “the natural or legal person has borrowed the share or has made alternative provisions resulting in a similar legal effect;

b) the natural or legal person has entered into an agreement to borrow the share or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due;

c) the natural or legal person has an arrangement with a third party under which that third party has confirmed that the share has been located and has taken measures vis-à-vis third parties necessary for the natural or legal person to have a reasonable expectation that settlement can be effected when it is due.”

For the short selling of sovereign debt, the European regulator determined a similar set of conditions to be fulfilled in order for the short sale to constitute a covered short sale in article 13, section 1 of Regulation (EU) No 236/2012:

a) “the natural or legal person has borrowed the sovereign debt or has made alternative provisions resulting in a similar legal effect;

b) The natural or legal person has entered into an agreement to borrow the sovereign debt or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due;

c) The natural or legal person has an arrangement with a third party under which that third party has confirmed that the sovereign debt has been located or otherwise has a reasonable expectation that settlement can be effected when it is due.”

If none of these conditions are met, the short sale is considered to be naked, and therefore forbidden.

The two sets of ‘conditions’ set out in articles 12 and 13 of Regulation (EU) No 236/2012 in fact form an exhaustive list of ways for a short seller to cover a short sale. These ways are mainly similar for the short selling of both shares and sovereign debt. For both types of short selling, we will not address condition (a) any further, as the functioning of a securities lending
agreement as a means for the coverage of a short sale has already been explained. Condition (b) will be analysed simultaneously for the short selling of shares as well as sovereign debt, as it is the same for both types of short selling. Finally, condition (c) will be addressed separately for the short selling of sovereign debt and shares.

3.1. Coverage by securities lending agreement and the alternative of the absolutely enforceable claim

The European conditions for the coverage of short selling are similar to those set out in the Belgian Royal Decree of 23 September 2008. Yet, the European short selling regulation is a bit more lenient towards short sellers. Whereas the Belgian regulation required short sellers to have entered into a securities lending agreement or have bought the securities before the sale, the European short selling regulation allows short sellers to cover their short sales in other ways as well.

The second condition included in article 12 of this Regulation stipulates that a short sale is also covered if the short seller, instead of entering into a securities lending agreement, has an absolutely enforceable claim to be transferred ownership of the shares that he sold short in order for the settlement to be effected properly. This allows short sellers more latitude in covering their short sales.

(i) Types of absolutely enforceable claims

Article 5, section 1 of the Commission Implementing Regulation (EU) No 827/2012 (from here on called Regulation No 827/2012) determines which claims qualify as an absolutely enforceable claim to be transferred ownership of the shares in the sense of article 12, section 1(b) of Regulation (EU) No 236/2012. The following agreements, contracts or claims, if legally binding, qualify as such:

(a) futures and swaps

A future is a forward contract, obligating the user to buy or sell an asset at a specific price on a specific date in the future. A swap is a contract by which two parties exchange the cash flow linked to a liability or an asset.254

In order for a futures or swaps contract to qualify as coverage of a short sale, it must lead to a physical settlement of the relevant shares or sovereign debt.

254 These definitions were retrieved from “Economics a-z”, The Economist, http://www.economist.com/economics-a-to-z.
(b) options
An option contract too must lead to a physical settlement of the relevant shares or sovereign debt in order for it to cover a short sale.\textsuperscript{255}

(c) repurchase agreements
A repurchase agreement, also known as a repo, is a short-term loan, whereby the seller of a security agrees to buy it back at a specified price and time. The seller pays an interest rate, called the repo rate, when buying back the securities.\textsuperscript{256}

(d) standing agreements or rolling facilities
By allowing these types of coverage, the regulator intended to include continuing agreements in which the short seller, within a certain period, (continuously) buys assets.

(e) agreement relating to subscription rights
A subscription right is the right of an existing shareholder to subscribe to shares of a new issue of common stock before it is offered to the public.\textsuperscript{257} In order for such an agreement to sufficiently cover a short sale, rules have to be specified that ensure that the shares resulting from the subscription rights are available on or before the settlement date and in a quantity at least equivalent to the number of shares intended to be sold short.\textsuperscript{258}

(f) other claims or agreements leading to delivery of the shares or sovereign debt
By allowing “other claims or agreements leading to delivery of the shares or sovereign debt”, the European regulator makes clear that the list of absolutely enforceable claims is in no way exhaustive.

(ii) Requirements
In order for any of the aforementioned contracts to qualify as coverage of short sales in the sense of article 12 and 13 of Regulation (EU) No 236/2012, several conditions must be met:

- the contract or claim covers at least the number of shares or amount of sovereign debt sold short by the short seller;
- the contract was entered into or the claim went into effect no later than the time of the short sale;

\textsuperscript{255} For a definition of an option contract, see page 11.
\textsuperscript{256} “Lexicon”, Financial Times, \url{http://lexicon.ft.com/Term?term=repurchase-agreement}.
\textsuperscript{258} Point (8) of the preamble to Regulation (EU) No 827/2012.
the delivery, expiration, repurchase or execution date of the contract or claim ensures that settlement can be effected when due.

Furthermore, article 5(2) of Regulation (EU) No 827/2012 states that the contract or claim must be provided in a durable medium by the counterparty to the short seller as evidence of its existence.

3.2. Coverage by arrangements with third parties: the locate rule
In case a short seller is unable or unwilling to enter into a securities lending agreement or to make one of the abovementioned agreements, the European regulation still provides a means for him to cover his short sale. Articles 12(1)(c) and 13(1)(c) of Regulation (EU) No 236/2012 determine that a short sale is covered, and therefore allowed, when the short seller has an arrangement with a third party under which the latter has confirmed that the relevant shares or sovereign debt have been located and that he has taken measures in order for the short seller to reasonably expect that the settlement of the short sale can be effected when due. This is called the ‘locate rule’. These measures have to be taken by the short selling entity itself and not by a third party belonging to the same corporate group of the short selling entity.

(i) Qualified third parties
The third parties with whom arrangements may be made in order to cover a short sale are subject to strict conditions. Evidently so, since the abovementioned arrangements are meant to ensure the settlement of the short sale and the adequacy of the guarantee for settlement relies on the reliability of the third party.

This third party cannot be another legal entity within the same corporate group in which the short seller is included.

Article 8(1) of Regulation (EU) No 827/2012 determines the different entities that qualify as third parties in the sense of article 12(1)(c) or 13(1)(c) of Regulation (EU) No 236/2012. Below, we will address these different entities.

(a) Investment firms

Investment firms only qualify as third parties if they meet the following conditions:262

- they participate in the management of borrowing or purchasing of relevant shares or sovereign debt;
- they provide evidence of such participation;
- they are able, on request, to provide evidence of their ability to deliver or process the delivery of shares or sovereign debt on the date they commit to do so to their counterparties including statistical evidence.263

(b) Central counterparties

Article 2(c) of Directive 98/26/EC of the European Parliament and of the Council defines central counterparties as entities interposed between the institutions in a system that acts as the exclusive counterparty of these institutions with regard to their transfer orders. In other words, a central counterparty ensures that investors do not buy and sell to each other directly, so there is no risk that one side will not pay what is owed.264 Commonly, central counterparties are clearing houses. In order for the central counterparty to qualify as a third party, it is required that it clears the relevant shares or sovereign debt.265

(c) Securities settlement systems

Article 2(a) of Directive 98/26/EC of the European Parliament and of the Council defines a securities settlement system as a formal agreement between two or more participants266 with common rules and standardised arrangements for the execution of transfer orders between the participants, governed by the law of a Member State chosen by the participants267 and designated as a system and notified to the Commission by the Member State whose law is applicable, after that Member State is satisfied that the rules of the system are adequate.

The counterparty of the short seller in the securities settlement system can only act as a third party if it settles payments in respect of the relevant shares or sovereign debt.268

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262 Point (a) of article 8(1) of Regulation (EU) No 827/2012.
263 Article 8(2) of Regulation (EU) No 827/2012.
265 Point (b) of article 8(1) of Regulation (EU) No 827/2012.
266 Not including settlement agents, central counterparties, clearing houses or indirect participants.
267 The participants may only choose the law of a Member State in which at least one of them has its head office.
268 Point (c) of article 8(1) of Regulation (EU) No 827/2012.
(d) Central banks
A central bank may act as a third party in the sense of article 12(1)(c) or 13(1)(c) of Regulation (EU) No 236/2012 on the condition that it accepts the relevant shares or sovereign debt as collateral or conducts open market or repo transactions in relation to the relevant shares or sovereign debt. 269

(e) National debt management entities
Only the national debt management entity of the relevant sovereign debt issuer may act as a third party in an arrangement for the coverage of a short sale of sovereign debt. 270 An example of a national debt management entity is the UK Debt Management Office (DMO), the main responsibilities of which, among other things, “include debt and cash management for the UK Government, lending to local authorities and managing certain public sector funds”. 271 The DMO can only act as a third party in an arrangement covering a short sale of UK sovereign debt.

(f) Certain persons subject to authorisation or registration requirements by a Member State
Any other person who does not fall under one of the abovementioned descriptions can qualify as a third party, if this person is subject to authorisation or registration requirements in accordance with Union law by a member of the European System and meets the same requirements as those that have to be met by the investment firms. 272, 273

(g) Certain persons established in third countries
Persons who do not fall under one of the descriptions above and are not subject to authorisation or registration requirements by a Member States can also qualify as a third party if they meet several conditions. A person established in a third country who is authorised or registered and subject to supervision by an authority in that third country can make an arrangement with a short seller as a third party in the sense of articles 12(1)(c) and 13(1)(c) of Regulation (EU) No 236/2012 if that person meets the same requirements as those put out for investments firms. Furthermore, the third country’s supervisory authority referred to must be a party to an appropriate cooperation arrangement concerning exchange of information with the relevant competent authority.

269 Point (d) of article 8(1) of Regulation (EU) No 827/2012.
270 Point (e) of article 8(1) of Regulation (EU) No 827/2012.
272 These conditions are set out in article 8(2) of Regulation (EU) No 827/2012.
273 Point (f) of article 8(1) of Regulation (EU) No 827/2012.
(ii) Coverage of short sales of shares by arrangements in the sense of article 12(1)(c) of Regulation (EU) No 236/2012

Article 6 of Regulation (EU) No 827/2012 establishes three types of locate arrangements and determines specific requirements for each of these arrangements.

(a) Standard locate arrangement

The first arrangement is the standard locate arrangement. For this type of arrangement, two confirmations are required by the third party:

The locate confirmation

The locate confirmation is the confirmation provided by the third party, prior to the short sale, that it can make the relevant shares available for settlement in due time, taking into account the amount of the possible sale and market conditions. The locate confirmation also indicates the period during which the shares are located.\(^{274}\) The locate confirmation is actually a guarantee given by a third party that in case the short seller fails to deliver, it will make sure that the settlement will be executed anyway.

The put on hold confirmation

This is the confirmation by the third party, provided prior to the short sale, that it has at least put on hold the requested number of shares for the short seller.\(^{275}\) For example, a large shareholder providing a put on hold confirmation promises the short seller not to sell or lend a certain amount of shares of a certain type he currently owns.

(b) Standard same day locate arrangement

This arrangement was introduced by the regulator to facilitate intraday trading (also known as day trading). Day traders are investors who buy and sell the same stock on a single day in order to make a quick profit.\(^{276}\)

For intraday traders, considering the speed at which they buy or sell securities, it is almost impossible to first enter into a securities lending agreement before short selling a share. Therefore, in order to cover their short sales, they are bound to make use of the arrangements set out in article 6 of Regulation (EU) No 827/2012. However, the abovementioned standard locate arrangement was found to be too strict for this particular type of short selling. The

\(^{274}\) Point (a) of article 6(2) of Regulation (EU) No 827/2012.

\(^{275}\) Point (b) of article 6(2) of Regulation (EU) No 827/2012.

regulator considered it unnecessary to automatically obligate the third party to put on hold the relevant shares, because the short seller intends to cover his short sale on the same day by closing his short position.

The standard same day locate arrangement, designed specifically to meet the needs of short selling intraday traders, still made the fulfilment of several conditions required however. The following elements have to be present in order for the short sale to be covered:

The locate confirmation

The locate confirmation with regard to the standard same day locate arrangement is identical to the locate confirmation by the third party in a standard locate arrangement.277

The easy to borrow or purchase confirmation

For shares that are easy to borrow or purchase, the regulator did not want to obligate the third party to put on hold the relevant shares. This would be unnecessary with regard to an intraday short sale, since such a short sale is covered by purchases on the same day it was executed. Therefore, the regulator only required the third party to make an easy to borrow or purchase confirmation. This is a more flexible variant of the put on hold confirmation. Instead of confirming that the requested number of shares have been put on hold for the short seller, the third party only has to confirm that the requested number of shares is easy to borrow or purchase. Here too, the third party has to take into account the market conditions and other available information on the supply of the shares.278

For shares that are not easy to borrow or purchase, the aforementioned confirmation by definition cannot be validly made. In this case, the regulator does require a put on hold confirmation from the third party in order to ensure settlement.279

The request for confirmation

In a standard same day locate arrangement, the short seller’s request for the abovementioned confirmations must state that the short sale will be covered by purchases during the day on which the short sale takes place.280 In order for the conditions of the standard same day locate

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277 Point (b) of article 6(3) of Regulation (EU) No 827/2012.
278 Point (c) of article 6(3) of Regulation (EU) No 827/2012.
279 Point (c) of article 6(3) of Regulation (EU) No 827/2012.
280 Point (a) of article 6(3) of Regulation (EU) No 827/2012.
arrangement to apply, the short seller thus must disclose to the third party that his short selling activities amount to intraday trading.

**Monitoring**

The short seller is obligated to monitor the number of shares he sold short but did not cover by purchases on the same day.\(^{281}\)

**Instructions in the event of failure to cover**

In case the short seller does not cover his short sale by purchasing the same type of shares, he has to monitor the number of shares he failed to cover\(^ {282}\) and send an instruction to the third party to purchase or borrow the number of shares he failed to cover.\(^ {283}\) This way, the short sale will be fully covered anyway.

**\(c\) Easy to borrow or purchase arrangement**

For the short selling of liquid shares, the European regulator also provides less strict conditions for the arrangement between the short seller and a third party in order to cover a short sale. In article 6(4) of Regulation (EU) No 827/2012, the regulator determines that these conditions apply to the following shares:

- shares that meet the liquidity requirements established in Article 22 of Commission Regulation (EC) No 1287/2006\(^ {284}\); or
- shares that are included in the main national equity index as identified by the relevant competent authority of each Member State and are the underlying financial instrument for a derivative contract admitted to trading on a trading venue.

Apart from the requirement that the request for confirmation by the short seller has to state that the latter will cover his short sale by purchasing the relevant shares, the conditions for the easy to borrow or purchase arrangement are identical to those of the standard same day locate arrangement. Here too, the third party is not required to confirm that it has put on hold the relevant shares. Requiring the third party to do so would be completely unnecessary, given the

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\(^{281}\) Point (d) of article 6(3) of Regulation (EU) No 827/2012.

\(^{282}\) Point (d) of article 6(3) of Regulation (EU) No 827/2012.

\(^{283}\) Point (e) of article 6(3) of Regulation (EU) No 827/2012.

\(^{284}\) Article 22 of Commission Regulation (EC) No 1287/2006 of 10 August (Regulation (EC) No 1287/2006) determines several conditions shares have to meet in order for them to be considered liquid, going from their average daily number of transactions to their daily turnover. We will not go into detail with regard to this article however, as doing so would divert us too much from our main subject.
liquidity and therefore the availability of the relevant shares. The confirmation by the third party that it can make the shares available for settlement sufficiently guarantees such settlement.

(iii) Coverage of short sales of sovereign debt by arrangements in the sense of article 13(1)(c) of Regulation (EU) No 236/2012

In order to cover short sales of sovereign debt, the European regulator allowed short sellers to make arrangements with third parties in similar fashion of the arrangements with regard to short sales of shares. In article 7 of Regulation (EU) No 827/2012 a list of the allowed arrangements is provided together with the conditions they must meet.

(a) Standard sovereign debt locate arrangement

Like in the standard locate arrangement with regard to the short sale of shares, in the standard sovereign debt locate arrangement, the third party has to confirm, prior to the short sale, that it can make the relevant sovereign debt available for settlement in due time, taking into account market conditions and indicating the period for which the sovereign debt is located. Since the regulator does not require the third party to put on hold the relevant sovereign debt, the locate confirmation is the only condition to be fulfilled in order to cover a short sale of sovereign debt by an arrangement in the sense of article 13(1)(c) of Regulation (EU) No 236/2012.

(b) Time limited confirmation arrangement

This arrangement is similar to the standard same day locate arrangement with regard to the short sale of shares. Also designed specifically for intraday traders, the time limited confirmation arrangement imposes a lighter obligation on the third party, who does not have to make the relevant sovereign debt available, but only needs to have a reasonable expectation that it can be purchased.

Statement by the short seller

In order for the lighter conditions of the time limited confirmation arrangement to apply, the short seller has to state to the third party that the short sale will be covered by purchases during the same day of the short sale. The same condition applies to the standard same day locate arrangement, although the regulation stipulates that in the latter arrangement this statement must be made in the request for confirmation by the short seller.

The reasonable expectation confirmation

285 Article 7(2) of Regulation (EU) No 827/2012.
286 Article 7(3) of Regulation (EU) No 827/2012.
As already mentioned, the third party has to confirm, prior to the short sale, that it has a reasonable expectation that the relevant quantity of sovereign debt can be purchased, taking into account the market conditions and other available information on the supply of the sovereign debt instruments on the day of the short sale.

(c) Unconditional repo confirmation arrangement

Because it would make no sense to require third parties that have unconditional access to the sovereign debt sold short by the short seller to additionally make available the relevant sovereign debt for settlement in due time, the European regulator created the unconditional repo confirmation arrangement. In this arrangement, the third party has to confirm it has a reasonable expectation that settlement can be effected when due because of its participation in a structural based arrangement that provides unconditional access to the relevant sovereign debt. These structural based arrangements can be organised or operated by a central bank, a debt management office or a securities settlement system.287

(d) Easy to purchase sovereign debt arrangement

This arrangement is similar to the easy to borrow or purchase arrangement in the sense of article 6(3)(c) of Regulation (EU) No 827/2012. In the easy to purchase sovereign debt arrangement, the third party only has to confirm that it has a reasonable expectation that settlement can be effected when due because the relevant sovereign debt is easy to borrow or purchase. Again, the third party has to take into account the market conditions and any other available information on the supply of the sovereign debt.288

4. Evaluation of the prohibition of naked short selling

4.1. Achievement of the objectives

On 3 June 2013, the ESMA published a report evaluating the European short selling regulation.289 In this report, the ESMA, among other things, evaluates the impact of the prohibition of naked short selling of shares and sovereign debt.290 With regard to this prohibition, the ESMA intended to investigate the effects on price formation and volatility on

287 Article 7(4) of Regulation (EU) No 827/2012.
288 Article 7(5) of Regulation (EU) No 827/2012.
the one hand, and the amount of settlement failures on the other hand. In order to study these effects, the ESMA compared the average of different metrics before and after the Regulation for European shares with the evolution of those same metrics for US shares.

However, given the fact that all provisions on short selling were installed simultaneously, it is difficult to attribute the results of this comparison to one such provision. Taking this into account, although the ESMA did notice a slight decline in volatility of EU stocks compared to US stocks, we cannot ascribe this effect to the prohibition of naked short selling. Yet, it is an indication that in respect to decreasing volatility, the European prohibition of naked short selling is successful.

The quantitative analysis on the impact of the naked short selling prohibition on settlement fails conducted by the ESMA was also cautiously positive. The ESMA proves that after the entry into force of the Regulation, there were fewer settlement fails both in terms of volume and value in the European Union. The ESMA sees this as an indication that the European short selling regulation increases settlement discipline. However, the ESMA points out that its data might not be entirely reliable due to significant differences among countries concerning the definition of settlement fails. We regret the fact that the ESMA did not compare the results of this analysis to US stocks. One could argue that around November 2012, when the financial crisis was past its peak, speculative short selling is likely to have decreased, leading to less settlement failures. A comparison of the decrease of settlement failures after the entry into force by the European short selling regulation with the settlement failures in the US would have provided stronger evidence for the regulation’s success.

However, short sale restrictions typically come at a cost. In its report, the ESMA observes a decrease of price efficiency after the entry into force of the regulation. The ESMA estimates that after the European short selling regulation entered into force, price discovery slowed down by 3% more for EU stocks than for US stocks. This result was to be expected given the many studies pointing to the negative effects of short sale restrictions.

Although the results seem moderately positive, in our opinion, the prohibition of naked short selling as a way to overcome settlement failures is still excessive. By only imposing strict settlement periods and penalties for those who fail to settle, the European legislator would have reached this objective as well,\textsuperscript{294} without causing the damage to the market that inevitably follows restrictions on short selling.

4.2. European moderation and national severity

In our opinion, the success of the European regulation, compared to the failure of the short selling regulations in the UK, can partly be attributed to the European leniency towards short sellers. By prohibiting holding a net short position, the UK FCA imposed a very severe restriction on short selling, as investors could only use it to hedge a long position. The effects were, as studies have shown, detrimental for the economy. By imposing less constraints on short sellers, the negative effects typically caused by short selling restrictions are less severe with regard to the European short selling regulation. Furthermore, the fact that the European short selling regulation does not allow national competent authorities to permanently ban naked as well as covered short selling can only be beneficial for the economy.

The Belgian FSMA imposed a less severe restriction on short selling, initially only banning naked short selling. Yet, liquidity of the ‘protected’ shares has been proven to be affected negatively. Although there are indications that the European short selling regulation has a negative impact on liquidity as well\textsuperscript{295}, we suspect this impact to be less severe. This is because the European short selling regulation does not obligate short sellers to cover their short positions by entering into a securities lending agreement, unlike the Belgian short selling regulation. Negotiating a securities lending agreement may be costly and may take some time. The arrangements short sellers can make with third parties with regard to the locate rule in the European short selling regulation is far easier and cheaper. Here, the short seller is not obligated to first find a shareholder willing to lend out the relevant shares. Instead, he only needs to turn to a qualified third party who merely needs to locate the relevant shares.\textsuperscript{296} By making it easier for short sellers to cover their shares as to fall outside the scope of the ban on naked short selling.


\textsuperscript{296} That is, if these shares are easy to borrow or purchase.
selling, the European regulation restricts short selling far less than Belgian regulation did, especially considering Belgian regulation banned both naked and covered short selling in 2011.

We assume that Belgian regulation did lead to a decrease of settlement failures. However, in order to do so, it restricted short sellers more than the European regulation did. Since both regulations ensure the settlement of short sales, we prefer the European ban on naked short selling. Yet, in the light of the many economic studies proving the benefits of short selling and the costs of short sale constraints we regret the permanent short sale restriction introduced by the European Union.

Subsection 2. The buy-in procedures in case of failed settlements

In case of such a failure to deliver, article 15 of Regulation (EU) No 236/2012 requires the central counterparty in a Member State that provides clearing services for shares to take certain steps in order to deliver the shares to the buyer and to put pressure on the short seller.

First of all, the central counterparty has to ensure that if a short seller is unable to deliver the shares for settlement within four business days after the day on which settlement is due, procedures are automatically triggered for the buy-in of the shares to ensure delivery for settlement.\(^{297}\) The costs of the buy-in by the central counterparty will eventually be reimbursed by the short seller who failed to settle.\(^{298}\)

If the buy-in of the shares is impossible, the central counterparty must pay an amount of money to the buyer based on the value of the shares to be delivered at the delivery date. Additionally, the losses incurred by the buyer as a result of the settlement failure need to be compensated.\(^{299}\) Again, the short seller fully reimburses the central counterparty.\(^{300}\)

Evidently, these rules are not beneficial for central counterparties such as clearing houses. If an insolvent short seller fails to deliver after a naked short sale, the central counterparty is unlikely to be reimbursed. Hence, central counterparties are likely to make sure that they do not go in business with naked short sellers. This way, the provisions in article 15 of the European Regulation on Short Selling not only lead to the protection of whomever buys shares from short sellers, but also serves as a way of lowering the amount of naked short sales.\(^{301}\) However, not

\(^{297}\) Point (a) of article 15(1) of Regulation (EU) No 236/2012.
\(^{298}\) Point (c) of article 15(1) of Regulation (EU) No 236/2012.
\(^{299}\) Point (b) of article 15(1) of Regulation (EU) No 236/2012.
\(^{300}\) Point (c) of article 15(1) of Regulation (EU) No 236/2012.
\(^{301}\) Slaughter and May, “The European Regulation on short selling and CDS”, Briefing, July 2012, 5.
only the amount of naked short selling can be expected to be lowered by the provisions in article 15. In order to compensate the risk that they may fail to recover the amounts referred to earlier, central counterparties are likely to impose additional margining or other default requirements to short sellers.\textsuperscript{302} The provisions of article 15 of Regulation (EU) No 236/2012 therefore indirectly raise the costs of both naked and covered short selling.

Besides protecting the interests of the buyer in the ways mentioned above, the central counterparty also has a supervisory function. The European legislator requires the central counterparty to impose daily fines on short sellers who fail to deliver for each day that the failure continues. These daily fines must be sufficiently high in order for them to deter short sellers from failing to deliver.\textsuperscript{303}

The provisions in article 15 of Regulation (EU) No 236/2012 only apply to short selling of shares.

\textbf{Subsection 3. The disclosure rule}

Besides a prohibition on naked short selling, the European regulator also installed disclosure requirements for short sellers. The purpose of these requirements is the enhancement of transparency of the market. In short, the disclosure rule works as follows: an investor, holding a net short position in a certain company or sovereign debt discloses this position to the competent national authority or the market, depending on the size of his position. The information gathered by the competent national authorities is then transferred to the ESMA.

In this section we will first address the information that has to be included in all types of disclosures. Subsequently, we will address the difference disclosure rules; first the disclosure rules concerning net short positions in shares, then those with regard to net short positions in sovereign debt.

The disclosure rules apply to investors established both within the European Union and in third countries.\textsuperscript{304}

\textsuperscript{302} Slaughter and May, “The European Regulation on short selling and CDS”, \textit{Briefing}, July 2012, 5.
\textsuperscript{303} Article 15(2) of Regulation (EU) No 236/2012.
\textsuperscript{304} Article 10 of Regulation (EU) No 236/2012.
1. The European meaning of the term “net short position”

1.1. Net short position

The disclosure rule in the European short selling regulation does not only apply to short selling transactions as we defined it on page 3 of this thesis. Instead, the European legislator has required investors who hold a certain net short position in certain shares or sovereign debt to disclose this position to the relevant competent authority or the market. In order to understand the disclosure rule, we need to have a good understanding of what the European regulator considers to be a “net short position”.

A net short position is, as we have already learned, typically the positive result of deducting an investor’s short position by his long position in a certain financial instrument. In the European regulation, this is not any different. The European legislator only defines net short positions in relation to issued share capital or issued sovereign debt. This is logical, as the disclosure rules in the European short selling regulation only apply to short positions in issued share capital or sovereign debt.

In the European short selling regulation, a net short position in relation to the issued share capital of a company is defined as the position remaining after deducting any long position that a person holds in relation to the issued share capital from any short position that that person holds in relation to that capital. 305

The European legislator defines a net short position in relation to issued sovereign debt as the position remaining after deducting any long position that a person holds in relation to issued sovereign debt and any long position in debt instruments of a sovereign issuer the pricing of which is highly correlated to the pricing of the given sovereign debt from any short position that that person holds in relation to the same sovereign debt. 306

As the net short position is calculated by deducting a short position with a long position, we need to understand what the European regulator considers to be a short or long position. For the sake of clarity, the European legislator defined both terms.

1.2. Short position

Article 3(1) states that a short position results from either of the following:

305 Article 3(4) of Regulation (EU) No 236/2012.
306 Article 3(5) of Regulation (EU) No 236/2012.
(a) a short sale of a share issued by a company or of a debt instrument issued by a sovereign issuer;

(b) entering into a transaction which creates or relates to a financial instrument other than an instrument referred to in point (a) where the effect or one of the effects of the transaction is to confer a financial advantage on the natural or legal person entering into that transaction in the event of a decrease in the price or value of the share or debt instrument.

The European legislator intended to make the scope of the term “short position” as wide as possible in order to make it impossible for investors to create transactions to which the disclosure rules do not apply. In this sense, the European definition of a short position is very similar to the UK definition of a (disclosable) short position. In the disclosure rule installed in June 2008, a disclosable short position was defined as a position that directly or indirectly relates to securities which are the subject of a rights issue. Although shorter, the meaning of this definition is essentially similar.

1.3. Long position

Although they are exact opposites, the definitions of a long position and a short position are very similar. Article 3(2) defines a long position as a position resulting from either of the following:

(a) holding a share issued by a company or a debt instrument issued by a sovereign issuer;

(b) entering into a transaction which creates or relates to a financial instrument other than an instrument referred to in point (a) where the effect or one of the effects of the transaction is to confer a financial advantage on the natural or legal person entering into that transaction in the event of an increase in the price or value of the share or debt instrument.

1.4. Positions held indirectly

In article 3(3) of Regulation (EU) No 236/2012, the European legislator states that positions held indirectly by the investor, either short or long positions, have to be included in the calculation of the net short position. The European regulator provides several examples of means by which an investor can indirectly hold a short or long position in a specific share or

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307 Article 2(a) of Regulation (EU) No 236/2012 defines a “financial instrument” as an instrument listed in section C of Annex I to Directive 2004/39/EC, also known as MiFID I.


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sovereign debt. Holding a position in an index, a basket of securities or any exchange traded fund or similar entity, can lead to a short or long position in a specific share or sovereign debt in the sense of article 3(1) or 3(2) of the Regulation.

Given the definitions provided in article 3(1) or 3(2) of the Regulation, in our opinion, the inclusion of these indirect positions in the calculation of the net short position was already established. These definitions already state that any transaction that relates to a financial instrument and leads to a financial advantage in case of an increase or decrease in the price or value of that instrument, constitutes a long or short position. Holding an interest in an index fund in our opinion qualifies as entering into a transaction relating to the financial instruments included in that index. Since an investor holding a long position in an index evidently benefits financially from an increase of the price of a certain share included in that index, and vice versa, the aforementioned definitions apply unabatedly.

However, article 3(3) of the Regulation serves an important purpose. On the basis of the definitions provided in article 3(1) and 3(2), positions held indirectly by an investor have to be included in the calculation of the net short position in any case. Refraining from doing so, would then constitute a violation of the European short selling regulation. Often, however, it is difficult to know the exact interest in a certain share resulting from a position in an index fund or exchange traded fund, especially considering that these funds may trade at a fast rate and change their positions constantly. In such cases, it may be possible the investor has no way of knowing his exact position in the specific included shares. Therefore, in article 3(3), the European regulator states that a position held indirectly must be determined by the holder of this position acting reasonably having regard to publicly available information as to the composition of the relevant index or basket of securities, or of the interests held by the relevant exchange traded fund or similar entity. Furthermore, article 3(3) emphasises that nobody is required to obtain any real-time information from any person in order to calculate such composition. With article 3(3), the European regulator intended to prevent that investors in indices, exchange traded funds or similar entities were automatically considered to have violated the European short selling regulation, even if there was no way for them to have knowledge of such a violation or if obtaining this knowledge would have been excessively difficult.
2. The disclosed information

Significant net short positions in shares as well as sovereign debt\(^{309}\) have to be disclosed. With regard to the former type of short position, there are two types of disclosure: the notification of the net short position to the competent authority and the disclosure of the net short position to the public.

Each of these notifications or disclosures must state the identity of the person holding the relevant position, the size of this position, the issuer in relation to which the position is held and the date on which the position was created, changed or ceased to be held.\(^{310}\)

3. Types of disclosure

3.1. Disclosure of net short positions in shares

(i) Disclosure to the competent authority

According to article 5(1) of Regulation (EU) No 236/2012, a person who has a net short position in a company that has shares admitted to trading on a trading venue shall notify the relevant competent authority when the position reaches or falls below a relevant notification threshold. A relevant notification threshold is a percentage that equals 0,2 % of the issued share capital\(^{311}\) of the company concerned and each 0,1 % above that.\(^{312}\) Compared to the Belgian and UK regulation, the European regulation was more strict. In Belgium as well as the UK, disclosure was only required when an investor held a net short position of 0,25 % of the issued share capital. The European Commission may modify these thresholds on its own initiative\(^{313}\) or after the ESMA has issued an opinion on adjusting the thresholds to the Commission.\(^{314}\)

Regarding the disclosure of a net short position in shares of a certain company, the relevant competent authority to which the short seller should disclose his position is the competent authority of the member state where the share was first admitted to trading on a regulated market.\(^{315}\) For shares first admitted to trading on the Belgian regulated market, this authority is

\(^{309}\) According to article 2(f) of Regulation (EU) No 236/2012, “sovereign debt” amounts to any debt instrument issued by a sovereign issuer.

\(^{310}\) Article 9(1) of Regulation (EU) No 236/2012.

\(^{311}\) Article 2(g) of Regulation (EU) No 236/2012 defines “issued share capital” as the total of ordinary and preference shares issued by a company, not including convertible debt securities.

\(^{312}\) Article 5(2) of Regulation (EU) No 236/2012.

\(^{313}\) Article 5(4) of Regulation (EU) No 236/2012.

\(^{314}\) Article 5(3) of Regulation (EU) No 236/2012.

\(^{315}\) Article 2(j) of Regulation (EU) No 236/2012; articles 2(7) and 9(2) of the Commission Regulation (EC) No 1287/2006.
the FSMA. In the UK, the competent authority to which net short positions need to be disclosed is the FCA. Disclosable net short positions in shares that were first admitted to trading on more than one regulated market in different member states need to be notified to the most relevant market in terms of liquidity for those shares.

The relevant competent authority must ensure the confidentiality of the information. Furthermore, it needs to install mechanisms for authenticating the source of the notification.

(ii) Disclosure to the public

When the short seller’s net short position amounts to 0.5% of the issued share capital of the company concerned, he must disclose details of that position to the public. Furthermore, having reached a net short position of 0.5% of the issued share capital, he must continue to do so for each increase of 0.1% of his net short position. Again, the ESMA may issue an opinion on adjusting these thresholds to the European Commission, which has the authority to do so.

The public disclosure must be made in such a manner that fast access to information is ensured on a non-discriminatory basis. The European legislator requires the disclosed information to be posted on a central website operated by the relevant competent authority (i.e. the FSMA or FCA). On the website of the ESMA, a list of all such central websites is provided.

3.2. Disclosure of net short positions in sovereign debt

(i) Notification thresholds

As mentioned previously, the European legislator decided not to install a public disclosure requirement of a net short position in sovereign debt, as this would send a negative signal about a market that may already be instable.

A person who has a net short position relating to issued sovereign debt must notify the relevant competent authority, whenever this positions reaches or falls below the notification thresholds for the sovereign issuer concerned. The European legislator delegated the authority to set

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317 Section 2.5.1. Financial Stability and Market Confidence Sourcebook.
319 Article 9(3) of Regulation (EU) No 236/2012.
320 Articles 6(1) and (2) of Regulation (EU) No 236/2012.
321 Articles 6(3) and (4) of Regulation (EU) No 236/2012.
322 This list is available on the following website: http://www.esma.europa.eu/system/files/ssr_websites_ss_positions_version_02_april_2014.pdf.
323 Article 7(1) of Regulation (EU) No 236/2012.
these thresholds to the Commission.\textsuperscript{324} This delegation of authority is not unconditional, however, as the legislator requires the Commission to do the following when setting the thresholds concerned:

(a) ensure that the thresholds are not set at such a level as to require notification of positions which are of minimal value;
(b) take into account the total amount of outstanding issued sovereign debt for each sovereign issuer, and the average size of positions held by market participants relating to the sovereign debt of that sovereign issuer; and
(c) take into account the liquidity of each sovereign bond market.\textsuperscript{325}

In Chapter VI of the Commission Delegated Regulation (EU) No 918/2012, the Commission used this authority to set the thresholds for the disclosure of net short positions in sovereign debt. These thresholds are the following:

(a) an initial threshold of 0.1 % applicable where the total amount of the outstanding issued sovereign debt is between 0 and 500 billion euro;
(b) a threshold of 0.5 % applicable where the total amount of the outstanding issued sovereign debt is above 500 billion euro or where there is a liquid future market for the particular sovereign debt.\textsuperscript{326}

For short sellers who already have net short positions in sovereign debt amounting to the thresholds mentioned above, the Commission also determined by which percentage these positions have to increase in order for the short sellers to notify the competent authority of such increase:

(a) each 0.05 % above the initial notification threshold of 0.1 % where the total amount of the outstanding issued sovereign debt is between 0 and 500 billion euro;
(b) each 0.25 % above the initial notification threshold of 0.5 % where the total amount of the outstanding issued sovereign debt is above 500 billion euro.\textsuperscript{327}

In order for an investor to know when he has to notify the relevant competent authority a net short position in sovereign debt, he needs to know the total amount of outstanding sovereign debt issued by the sovereign issuer he holds a net short position in. These amounts are available

\textsuperscript{324} Article 7(2) and (3) of Regulation (EU) No 236/2012.
\textsuperscript{325} Article 7(3) of Regulation (EU) No 236/2012.
\textsuperscript{326} Article 21(7) of the Commission Delegated Regulation (EU) No 918/2012.
\textsuperscript{327} Article 21(8) of the Commission Delegated Regulation (EU) No 918/2012.
on the website of the ESMA\textsuperscript{328} and updated quarterly for each sovereign issuer. At the time of writing this thesis, this list was last updated on 1 May 2015. With a total amount of outstanding debt of € 3.576 billion, the notification threshold for investors taking on a short position in Belgian sovereign debt is that of the abovementioned category (b). Because, as of 1 May 2015, the total amount of issued UK sovereign debt is € 21.750 billion, the same goes for investors holding a short position in UK sovereign debt.

(ii) Relevant competent authority

The authority to which investors holding a short position exceeding the aforementioned thresholds should notify this position depends on the issuer of the sovereign debt. If the sovereign debt was issued by a member state, this authority is the competent authority of that member state.\textsuperscript{329} For sovereign debt of members of a federal state (e.g. the Walloon region, the French Community, State of Bayern,...), the competent authority of the federal member state to which they belong must be notified.\textsuperscript{330} With regard to sovereign debt of the European Union, the competent authority is that of the jurisdiction in which the department issuing the debt is situated.\textsuperscript{331} Anyone holding a disclosable net short position in sovereign debt of the EU, therefore has to notify the Belgian FSMA. For sovereign debt issued by several member states acting through a special purpose vehicle or international financial institution established by two or more member states, the latter of which has the purpose to mobilise funding and provide financial assistance to the benefit of its members that are threatened by or are experiencing severe financial problems, the competent authority is that of the jurisdiction in which the special purpose vehicle or international financial institution is established.\textsuperscript{332,333} Disclosable net short positions in sovereign debt issued by the European Financial Stability Facility or the European Stability Mechanism must therefore be notified to the Luxembourg CSSF. Short positions in sovereign debt instruments issued by the European Investment Bank must be notified to the competent authority of the member state in which it is located,\textsuperscript{334} i.e. the Luxembourg CSSF. Disclosable net short positions in sovereign debt instruments that do not fit one of the

\textsuperscript{328} The overview of outstanding sovereign debt per sovereign issuer is available on the following website: http://www.esma.europa.eu/page/Net-short-position-notification-thresholds-sovereign-issuers.
\textsuperscript{329} In Belgium this is the FSMA; in UK the FCA.
\textsuperscript{330} Point (i) of article 2(j) of Regulation (EU) No 236/2012.
\textsuperscript{331} Point (ii) of article 2(j) of Regulation (EU) No 236/2012.
\textsuperscript{332} Point (iii) of article 2(j) of Regulation (EU) No 236/2012.
\textsuperscript{333} Point (iv) of article 2(j) of Regulation (EU) No 236/2012.
\textsuperscript{334} Point (vii) of article 2(j) of Regulation (EU) No 236/2012.
abovementioned descriptions must be notified to the competent authority of the member state in which the instrument was first admitted to trading.\textsuperscript{335}

Just like in case of the notification of shares, the competent authority must ensure the confidentiality of the received information and must install mechanisms for authenticating the source of the notification.\textsuperscript{336}

Section 2. Scope of the permanent regulatory provisions

In order to gain a full understanding of the scope of the permanent short selling provisions, we need to analyse several elements. First, we need to know to which financial instruments the prohibition of naked short selling and the disclosure rules apply. It has already been established that these financial instruments are either shares or sovereign debt instruments. However, we need to go further into detail and examine exactly which shares and sovereign debt instruments are protected by the European short selling regulation in order to know the scope of this regulation. In the first subsection of this section, we will address the scope of the European short selling regulation with regard to the financial instruments it protects.

Secondly, in order to know the scope of the regulation, it is imperative that we analyse who is subject to the European short selling regulation and if this regulation exempts certain groups of people from its field of application. In the second subsection of this section we will address the persons who are subjected to the European short selling regulation.

Subsection 1. The protected shares and sovereign debt

1. The protected shares

Shares fall under the disclosure requirements\textsuperscript{337}, the prohibition of naked short selling\textsuperscript{338} and the buy-in procedures\textsuperscript{339}, if the following two conditions are fulfilled:

- the shares are admitted to trading/traded on a trading venue\textsuperscript{340} (i.e. regulated market or MTF)\textsuperscript{341} in the European Union;

\textsuperscript{335} Points (v) and (vi) of article 2(j) of Regulation (EU) No 236/2012.
\textsuperscript{336} Article 9(3) of Regulation (EU) No 236/2012.
\textsuperscript{337} Articles 5 and 6 of Regulation (EU) No 236/2012.
\textsuperscript{338} Article 12 of Regulation (EU) No 236/2012.
\textsuperscript{339} Article 15 of Regulation (EU) No 236/2012.
\textsuperscript{340} Articles 5(1), 6(1) and 12(1) of Regulation (EU) No 236/2012.
\textsuperscript{341} Article 2(l) of Regulation (EU) No 236/2012.
• the principal trading venue for the share is in the European Union (and not in a third
country in case of multiple trading).  

In a Q&A, the ESMA illustrated this by giving the example of a company domiciled in the
USA, the shares of which are admitted to trading on a trading venue in Germany. If the principal
trading venue of this company is located in Germany, the abovementioned provisions apply. If
the principal trading venue is in the USA, these provisions do not apply.  

In order for investors to be able to know where the principal trading venue is located, the
European legislator introduced article 16(2) of Regulation (EU) No 236/2012, which obligates
the relevant competent authority for shares of a company that are traded on a trading venue in
the European Union and a venue in a third country to determine, at least every 2 years, whether
the principal venue for the trading of those shares is located in that third country. The authority
must notify the ESMA whenever they consider the principal trading venue of such shares to be
located in a third country.  

Based on this information, the ESMA publishes a list of shares traded on a trading venue in the European Union but with a principal trading venue in a third
country, which, in other words, amounts to a list of exempted shares.  

2. The protected sovereign debt
Article 2(f) of Regulation (EU) No 236/2012 defines sovereign debt as a debt instrument issued
by a sovereign issuer. According to article 2(d) of this Regulation, these sovereign issuers may
be one of the following:

(i) the European Union;
(ii) a Member State, including a government department, an agency or a special purpose
    vehicle of the Member State;
(iii) in the case of a federal Member State, a member of the federation;
(iv) a special purpose vehicle for several Member States;
(v) an international financial institution established by two or more Member States which
    has the purpose of mobilising funding and provide financial assistance to the benefit
    of its members that are experiencing or threatened by severe financial problems; or

342 Article 16(1) of Regulation (EU) No 236/2012.
343 ESMA/2012/666, “Implementation of the Regulation on short selling and certain aspects of credit default swaps
344 ESMA/2012/666, “Implementation of the Regulation on short selling and certain aspects of credit default swaps
345 Chapter V of the Commission Implementing Regulation (EU) No 827/2012 establishes further rules in relation
to the determination of the principal trading venue.
346 This list is available on the website of the ESMA: http://www.esma.europa.eu/page/List-exempted-shares.
For these reasons, the aforementioned provisions apply to any debt instrument issued by any of the abovementioned entities, regardless where they are being traded.

Subsection 2. Targeted investors

1. Overall

The disclosure or notification requirements, the prohibition of naked short selling and the buy-in procedure, according to the European short selling regulation, all apply to natural or legal persons. In the preamble of the Regulation, the European legislator stated that these “natural and legal persons” also include registered business associations without personality. In no way does the legislator limit the scope of the Regulation with regard to the persons subject to it.

In a Q&A about the new regulation on short selling, the ESMA clarified that neither the domicile or the establishment of the person entering into a transaction that falls within the scope of the European short selling regulation, nor the place where these transactions take place are of any relevance.\textsuperscript{347}

2. Exemptions

2.1. The market maker

Article 17(1) exempts transactions performed due to market making activities from the disclosure rules and the prohibition of naked short selling. The market maker exemption applies to regulation of short selling of both shares and sovereign debt.

(i) Market making activities

Article 2(k) defines market making activities as the activities of an investment firm, a credit institution, a third-country entity or a firm as referred to in point (i) of article 2(1) of MiFID 1, which is a member of a trading venue if it deals as principal in a financial instrument in any of the following capacities:

(i) by posting firm, providing liquidity on a regular and ongoing basis to the market;

(ii) as part of its usual business, by fulfilling orders initiated by clients or in response to clients’ requests to trade;

(iii) by hedging positions arising from the fulfilment of tasks under points (i) and (ii).

(ii) Third country market making activities

The activities of the institutions mentioned in article 2(k) that are not a member of a trading venue, but are a member of a market in a third country can also use the market making exemption. In order for them do so, one extra condition needs to be fulfilled however. In accordance with article 17(2) of Regulation (EU) No 236/2012, the European Commission must first determine that this third country has an equivalent legal and supervisory framework for its markets.\(^{348}\) Article 17(2) establishes several conditions for the legal and supervisory framework of the third country in order for it to be considered equivalent.

(iii) Procedure

In order to fall under this exemption, the market maker has to notify the competent authority of its home member state in writing that it intends to make use of this exemption.\(^{349}\) In case of any changes with regard to the market maker’s eligibility to use the exemption or if it no longer wishes to use the exemption, notification to this authority is also required.\(^{350}\) The notified competent authority has the authority to prohibit the use of the exemption if it considers that the person sending the notification does not fulfil the conditions of the exemption.\(^{351}\) In order to do so, the authority may request information about the alleged market maker’s short positions held and activities conducted under the exemption.\(^{352}\)

If the competent authority does not prohibit the person announcing the use of the exemption from doing so, it must notify the ESMA.\(^{353}\) On the basis of these notifications, the ESMA publishes a list of market makers using the exemption.\(^{354,355}\)


\(^{349}\) Article 17(5) of Regulation (EU) No 236/2012.

\(^{350}\) Article 17(9) of Regulation (EU) No 236/2012.

\(^{351}\) Article 17(7) of Regulation (EU) No 236/2012.

\(^{352}\) Article 17(11) of Regulation (EU) No 236/2012.

\(^{353}\) Article 17(12) of Regulation (EU) No 236/2012.

\(^{354}\) Article 17(13) of Regulation (EU) No 236/2012.

\(^{355}\) This list is available on the following URL: http://www.esma.europa.eu/system/files/list_of_market_makers_and_primary_dealers.pdf.
2.2. The authorised primary dealer

Article 17(3) of Regulation (EU) No 236/2012 determines that the disclosure rules and the prohibition of naked short selling of sovereign debt does not apply to the activities of a person acting as an authorised primary dealer.

Article 2(n) of Regulation (EU) No 236/2012 defines an authorised primary dealer as a person who signed an agreement with a sovereign issuer or has been formally recognised as such by or on behalf of a sovereign issuer and who, in accordance with that agreement or recognition, has committed to dealing as principal in connection with primary and secondary market operations relating to debt issued by that issuer.

The procedure for an authorised primary dealer to use the exemption of article 17(3) of the Regulation is identical to that of the market maker.

Section 3. Sanctioning

Subsection 1. Article 41 of Regulation (EU) No 236/2012

Article 41, § 1 of Regulation (EU) No 236/2012 obligates Member States to establish rules on penalties and administrative measures, applicable to infringements of the Regulation, and to take all measures necessary to ensure that they are implemented. The European regulator requires those penalties and administrative measures to be effective, proportionate and dissuasive. Member states are therefore authorised to establish the sanctioning of any violation of the European regulation on short selling.

In fear for regulatory inconsistency, the European legislator intended to limit the authority of member states in the creation of the sanctioning of violations of the European regulation on short selling. Article 41, § 2 gives the ESMA the authority to set out guidelines in order to ensure consistency among member states with regard to penalties and administrative measures. However, the ESMA refrained from doing so.

In order to ensure transparency with regard to the different sanctions installed by the member states, article 41, § 3 requires member states to notify the Commission and the ESMA of any rule they made on penalties and administrative measures in the sense of the first paragraph of
that article. According to article 41, § 4, the ESMA must publish a list of all the existing penalties and administrative measures applicable in each member state.\textsuperscript{356}

\textbf{Subsection 2. Sanctioning in Belgium}

In Belgium, the sanctioning of violations of the European short selling regulation was established by an amendment of the Law of 2 August 2002 on the supervision of the financial sector and on financial services by Article 28 of the Law of 30 July 2013.

The new article 37ter of the Law of 2 August 2002 states that for the sanctioning of the violations of the European short selling regulation, the sanctions for market abuse will apply. Because the sanctioning of market abuse remains unaltered, sanctions for violations of the European short selling regulation are identical to those following the violation of the Belgian regulation of short selling during the financial crisis. We will therefore not address these provisions again.

Although the amendment was only announced on 30 July 2013, the provisions on the sanctioning of the European Regulation on Short Selling went into effect on 1 November 2012.\textsuperscript{357}

\textbf{Subsection 3. Sanctioning in the UK}

In 2010, the UK legislator issued new provisions on short selling in the Financial Services and Markets Act, as a result of problems concerning the binding nature of the emergency measures during the financial crisis of 2008. Among these provisions is section 131G of the Financial Services and Markets Act, which establishes the sanctions of the violation of any short selling rules. These sanctions are similar to those applying to activities amounting to market abuse. Having been introduced in 2010, the new sanctions were initially not intended to apply to violations of European regulation. However, on the basis of point (a) of section 131G(1), the whole section 131G applies, if the FCA is satisfied that a person has contravened any provision of short selling rules. Since European regulations have direct application, section 131G also applies to violations of the European short selling regulation.

\footnotesize\textsuperscript{356} This list is available on the following URL: \url{http://www.esma.europa.eu/system/files/list_of_administrative_measures_and_sanctions.pdf}. \textsuperscript{357} Article 69 of the Law of 30 July 2013.
1. Sanctions

In case of a violation, the FCA may impose a penalty of such amount as it considers appropriate on both the violator or anyone who was knowingly concerned in the violation. In setting the amount of the penalty, the FCA must take into consideration the following elements:

(a) the contravention;
(b) the extent to which the contravention was deliberate or reckless; and
(c) whether the person on whom the penalty is to be imposed is an individual.

Instead of imposing a penalty, the FCA may also publish a censure statement. The FCA is obligated to send a copy of the censure statement to the person concerned.

2. Procedure

2.1. Warning notice

If the FCA proposes to take action, either by imposing a penalty or publishing a censure statement, it must first give the person it intends to take action against a warning notice. This warning notice must state the action which the FCA proposes to take and give the reasons for this proposed action. The warning notice must also include the amount of the penalty to be imposed or set out the terms of the statement to be published. Furthermore, the warning notice must specify a reasonable period of at least 28 days, within which the person to whom it is given may make representations to the FCA. After giving a warning notice, the FCA must decide within a reasonable period whether to give the person concerned a decision notice.

2.2. Decision notice

If the FCA decides to take action, it must give the violator a decision notice. Just like the warning notice, the decision notice must include the reasons for the decision to take action and state the amount of the penalty or set out the terms of the statement. The type of action

358 Points (a) and (b) of Section 131G(2) of The Financial Services and Markets Act 2000
359 Section 131J(2) of the Financial Services and Markets Act 2000.
360 Section 131G(3) of the Financial Services and Markets Act 2000.
361 Section 131J(a) of the Financial Services and Markets Act 2000.
362 Section 131H(1) of the Financial Services and Markets Act 2000.
363 Points (a) and (c) of section 387(1) of the Financial Services and Markets Act 2000.
364 Section 131H(2) and (3) of the Financial Services and Markets Act 2000.
365 Section 387(2) of the Financial Services and Markets Act 2000.
367 Point (b) of section 388(1) of the Financial Services and Markets Act 2000.
368 Section 131H(4) of the Financial Services and Markets Act 2000.
determined to be taken in the decision notice may not differ from the action proposed in the warning notice.369

2.3. Limitation period
The FCA may not take action against a person in the sense of section 131 of the Financial Services and Markets Act later than three years after the first day on which the FCA knew of the violation, unless the FCA has given a warning notice to this person within those three years.370 The FCA is considered to “know of the violation” from the moment it has information from which the violation can reasonably be inferred.371

2.4. Imposition of penalties: the statement of policy
The FCA must issue a statement of policy if it imposes a penalty on a person for the violation of the regulation on short selling. This statement must disclose the FCA’s policy with respect to the imposition of the penalty and its amount.372

Section 4. Evaluation of the European permanent regulation of short selling

There are not many studies available on the impact of the European short selling regulation on the economy. On 3 June 2012, however, the ESMA published a report in which it evaluated its newly imposed short selling regulation.

In its report of 3 June 2012, the ESMA was cautiously positive373 about the European short selling regulation, as there were strong indicators that it had achieved its objectives. Compared to US stocks, since the introduction of the regulation stock, the ESMA witnessed a slight decline in volatility of EU stocks.374 With regard to liquidity, the ESMA observed mixed effects and, although bid-ask spreads had declined, it was unable to draw clear conclusions on the regulation’s effect on liquidity.375 Compared to the clear negative impact on liquidity of the short selling restrictions in Europe during the financial crisis, we consider this a success. There

369 Section 388(2) of the Financial Services and Markets Act 2000.
370 Section 131G(4) and (5) of the Financial Services and Markets Act 2000.
372 Section 131J(1) of the Financial Services and Markets Act 2000.
373 The ESMA showed caution in relation to its findings because of the short time frame in which they had analysed the effects of the regulation and the risk of distortion by external factors.
are also indicators that the European disclosure rules have led to a decrease of the amount of settlement failures.\textsuperscript{376}

However, as we said earlier, short sale restrictions typically come at a cost. The ESMA reports a decrease of price efficiency after the entry into force of the regulation.\textsuperscript{377} The ESMA estimates that after the European short selling regulation entered into force, price discovery slowed down by 3\% more for EU stocks than for US stocks.

As mentioned before, these results are not conclusive to draw clear conclusions about the success of the European short selling regulation. There is an abundance of available literature enabling us to draw conclusions about the temporary short selling measures taken during the financial crisis. With regard to the European short selling regulation, this is not the case. The conclusions by the ESMA were drawn after such a short period of time that the ESMA itself doubts their reliability. However, even though, at the time of writing this thesis, almost two years have passed, the ESMA has not yet published a new report on the impact of the European short selling regulation. This is regrettable, as doing so would allow us to draw much clearer conclusions.

We strongly doubt that the long term effects of the European short selling regulation have had a beneficial impact on the economy. The many studies pointing out the negative effects of short selling restrictions, together with the work of FOTAK, RAMAN and YADAV,\textsuperscript{378} which shows the positive effect of naked short selling on the economy, make us doubt the beneficial influence the prohibition of naked short selling by the European Union is supposed to have.

**Chapter 4. The European framework for emergency measures**

All over Europe, the Financial crisis of 2008 exposed national regulators’ inability to react. This was no different in Belgium and the UK. Both countries lacked legislation allowing the government to swiftly take measures in exceptional conditions such as the financial crisis. The lack of a suitable legal framework forced the regulators of these countries to use their anti-

market abuse legislations as a legal backdoor, which caused problems regarding the binding nature of the emergency measures.

As all European countries had to take emergency measures within different legal frameworks, most of them not designed for this purpose, the financial crisis caused major regulatory fragmentation on the European financial markets. Fragmentation was particularly notable with regard to the regulation of short selling, because most European countries restricted different types of short selling of different types of financial instruments.

In order to ensure the proper functioning of the internal market and to improve the conditions of its functioning, the European Parliament considered it necessary to lay down a common regulatory framework with regard to the powers relating to short selling and to ensure greater coordination and consistency between member states where measures have to be taken in exceptional circumstances.\(^\text{379}\) The European short selling regulation contains a regulatory framework for measures against the short selling of all financial instruments in exceptional circumstances.

However, the European regulator did more than just provide a legal framework for national competent authorities to take measures against short selling in case of emergencies. The European Parliament also gave intervention powers to the ESMA. In case a member state refrains from using the European legal framework for emergency measures and does not take action against developments threatening the financial stability of the European Union, the ESMA itself can take emergency measures against short selling. In the UK, where the FCA soon realised the damage emergency measures against short selling cause, this led to protest and ultimately legal action.

In this chapter we will analyse the powers of the national competent authorities and the ESMA in exceptional circumstances. Subsequently, we will briefly address the legal action by the UK against the European Union.

\(^{379}\) Point (2) of the preamble to Regulation (EU) No 236/2012.
Section 1. Powers of the national authority in case of exceptional circumstances

Subsection 1. Powers of the national competent authority in case of adverse events or developments

In case of adverse events or developments constituting a serious threat to financial stability or to market confidence in one or more member states, the European short selling regulation allows the national competent authorities to take several measures with regard to short selling.\textsuperscript{380}

1. Adverse events or developments

Article 24 of the Commission Delegated Regulation (EU) No 918/2012 clarifies the meaning of an adverse event or development as referred to above by providing a series of effects that can reasonably be expected to be caused by the concerned event or development. By doing so, the European regulator allows the national competent authority to act quickly, as the latter does not have to prove that such effects will actually occur.

The European legislator lists the following effects, which, in case they are reasonably expected to be caused by the event or development, allow competent authority to take emergency measures:\textsuperscript{381}

\begin{itemize}
  \item[(a)] serious financial monetary or budgetary problems that may lead to the financial instability of member state or a financial institution;
  \item[(b)] a rating action or a default by a member state or financial institution that could reasonably be expected to cause severe uncertainty about their solvency;
  \item[(c)] substantial selling pressures or unusual volatility causing significant downward spirals in any financial instrument related to a financial institution operating within the EU or to a sovereign issuer;
  \item[(d)] relevant damage to the physical structures of important financial issuers, market infrastructures, clearing and settlement systems and supervisors that may affect markets, particularly when resulting from a natural disaster or terrorist attack;
  \item[(e)] relevant disruptions in the payment system or settlement process.
\end{itemize}

\textsuperscript{380} Article 20 of Regulation (EU) No 236/2012.
\textsuperscript{381} These measures have to fulfil the conditions set out in the subsection below.
2. Conditions
In addition to the condition of the existence of an adverse event or development as mentioned above, the European regulator determined two extra conditions for the imposition of emergency measures. First of all, the temporary measure must be necessary to overcome the threat referred to. Secondly, the measure’s negative effects on the efficiency of financial markets must be proportionate to its benefits. 382

3. Powers of the national authority

3.1. The disclosure of net short positions
For financial instruments of which there are no disclosure rules determined in the permanent regulation mentioned in the previous chapters, the national competent authority (i.e. the FSMA in Belgium and the FCA in the UK) can impose to anyone the obligation to disclose a net short position in relation to a specific financial instrument or type of financial instruments to the authority or to the market. 383

As this provision allows competent authorities to install disclosure rules on financial instruments that are not subject to transparency regulation yet, it allows competent authorities to obligate the holders of net short positions in the shares that are exempted on the basis of article 16 of the Regulation to nevertheless disclose these positions. Another example of financial instruments in relation to which competent authorities can install disclosure rules is a derivative admitted to trading on a trading venue that relates to shares that are not admitted as such.

3.2. The notification by lenders of financial instruments
The competent authority may require anyone engaged in the lending of a specific financial instrument or a class of financial instruments to notify any significant change in the fees requested for such lending. 384

3.3. The restriction on short selling and similar transactions
In the exceptional circumstances mentioned above, the competent authority may prohibit or restrict the short selling of any type of financial instruments or one specific financial instrument. This prohibition can also apply to transactions other than short sales that create or refer to a

382 Article 20(b) of Regulation (EU) No 236/2012.
383 Article 18 of Regulation (EU) No 236/2012.
financial instrument that leads to a financial advantage in the event of a decrease in the price or value of the financial instrument.  

The competent authority has been given a lot of freedom in restricting or prohibiting short selling in exceptional circumstances. Restrictions can be imposed on both naked and covered short selling of any financial instruments. Furthermore, the competent authority may provide exemptions, for example for market makers.

4. Duration of the measures

The abovementioned measures can be valid no longer than 3 months from the date of publication of the notice of restriction. The measures can be renewed for further periods of 3 months or less as long as the conditions for the imposition of such measures still apply.

Subsection 2. Powers of the national competent authority in case of a significant fall in price

1. European regulation

In the subsection above, we discussed the powers of the national authority in case of a serious threat to financial stability or market confidence. The European legislator considered it necessary to additionally give the national authorities the power to also protect one single company, even if there is no threat to financial stability. The following provision is intended to allow authorities to give a company some breathing space in times of financial duress.

If the price of a financial instrument on a trading venue has fallen significantly during a single trading day in relation to the closing price on that venue on the previous trading day, the competent authority of the home member state for that venue can restrict anyone from engaging in short selling of the financial instrument on that trading venue. For liquid shares, a fall in value of 10% or more amounts to a significant fall in price as mentioned above. For illiquid shares, article 23 of the Commission Delegated Regulation (EU) No 918/2012 determines different thresholds. The calculation of the significant fall is explained in the Commission Delegated Regulation (EU) No 919/2012.

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385 Article 20 of Regulation (EU) No 236/2012.
386 Article 20(3) of Regulation (EU) No 236/2012.
388 Article 23(1) of Regulation (EU) No 236/2012.
389 Article 23(5) of Regulation (EU) No 236/2012.
390 See footnote 284 for more explanation about which shares are considered liquid shares.
This measure cannot stay in place longer than the end of the trading day after the day on which the fall in price occurs. However, under certain conditions, renewal is possible for a total of 2 trading days.  

2. The UK implementation

In the UK, known for its reluctance in restricting short selling, the Financial Stability and Market Confidence Sourcebook in the FCA Handbook restricts the FCA in taking the measure referred to in this subsection. When considering to take this measure, the FCA must consider whether the price fall is or may become disorderly and whether the imposed measure will prevent a further disorderly decline in the price of the financial instrument. By requiring the price fall to be disorderly, the FCA restricts its own intervention powers in case of a significant fall in price of a financial instrument.

In analysing whether the price fall is or may become disorderly, the FCA must at least assess the following:

(1) whether there have been any violent movements in the price of the particular financial instrument on a particular trading venue;
(2) whether there is evidence of unusual or improper trading in the financial instrument that could indicate that there was pressure to set the price of the financial instrument at a level that would be considered abnormal for that instrument;
(3) whether there are unsubstantiated rumours or dissemination of false or misleading information regarding the financial instrument.

By requiring the FCA to analyse the above factors, it is clear that, in the UK, lessons have been learnt from the financial crisis of 2008. Regulators, such as the FCA, saw share prices fall severely and blamed this on the presence of abusive short sellers on the markets. Afterwards, the lack of evidence of any abusive short selling and the evidence of the damage to the market by short sale restrictions indicated that regulators had been rash in taking anti-short selling measures. The assessment of the abovementioned factors are an effective means of preventing this from happening again.

If there is no evidence of the disorderly nature of a price fall, the FCA shows no intention to intervene, even though the European short selling regulation allows it to do so. If the FCA

391 Article 23 of Regulation (EU) No 236/2012.
392 Section 2.5.1 of the Financial Stability and Market Confidence Sourcebook.
393 Section 2.5.2 of the Financial Stability and Market Confidence Sourcebook.
considers there is a legitimate cause for a price fall in trading, such as the announcement of poor financial results, it will consider the price fall is not disorderly.\textsuperscript{394} Given the abovementioned considerations by the FCA, in such case the FCA is highly unlikely to intervene.

Furthermore, the FCA expressed its intent to exempt market makers or authorised primary dealers on the basis of article 23(3) of Regulation (EU) No 236/2012 in case it were to impose the measure referred to.\textsuperscript{395}

**Subsection 3. Procedure**

1. **Notice of restriction**

When taking any of the aforementioned measures, the competent authority must publish a notice on its website. This notice consists of two main parts. First, it state the imposed measures, the instruments and transactions to which they apply and their duration. Secondly, the notice states why the authority believes the imposition of the measures to be necessary and provides evidence in support thereof. Only when this notice is published can the measures referred to enter into force.\textsuperscript{396}

2. **Notification to the ESMA and other competent authorities**

Before imposing or renewing any of the emergency measures referred to in this section, the competent authority must notify the ESMA and all other competent authorities.\textsuperscript{397}

**Section 2. Powers of the ESMA**

In exceptional circumstances, the ESMA has two responsibilities. First of all, the ESMA is tasked with the coordination of the measures against short selling taken by the competent authority of the member states of the European Union. Secondly, under certain conditions, the ESMA has the power to intervene and impose measures against short selling.

**Subsection 1. Coordination**

Given the fact that the main objective of the legal framework for measures against short selling in exceptional circumstances is regulatory consistency, the ESMA plays an important assisting

\[\textsuperscript{394} \text{Section 2.5.3 of the Financial Stability and Market Confidence Sourcebook.}\]
\[\textsuperscript{395} \text{Section 2.5.5 of the Financial Stability and Market Confidence Sourcebook.}\]
\[\textsuperscript{396} \text{Article 25 of Regulation (EU) No 236/2012.}\]
\[\textsuperscript{397} \text{Article 26 of Regulation (EU) No 236/2012.}\]
and coordinating role in relation to the measures taken within this framework. Within 24 hours after receiving the notification referred to earlier, the ESMA issues its opinion on the necessity of the measure and its potential negative effects on the markets. In other words, the ESMA evaluates whether the conditions set out on page 116 are fulfilled. The ESMA will also give its opinion on the duration of the measure. Finally, the ESMA will state in its opinion whether it considers measures by other competent authorities necessary to address the threat the proposed measure intends to overcome.\(^{398}\)

If a competent authority takes measures, or proposes to do so, contrary to the ESMA’s opinion, or if a competent authority declines to take measures even though the ESMA considered doing so necessary, the competent authority must publish a notice on its website in which it fully explains its reasons for doing so.\(^{399}\)

**Subsection 2. Intervention**

The ESMA’s powers are not only of assisting or coordinating nature. Under certain conditions, the ESMA can supersede the national competent authority and take emergency measures with regard to short selling where the latter omits to do so. In order for the ESMA to impose emergency measures, several conditions have to be fulfilled however.

**1. Conditions for the intervention by the ESMA**

The ESMA can only intervene when there are cross-border implications and a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the European Union.\(^{400}\) These threats are essentially the same as those set out in relation to the adverse events or developments that allow the national competent authority to impose measures.\(^{401}\)

Secondly, the ESMA can only intervene when no competent authority has taken measures to address to aforementioned threat or when a competent authority has taken measures that do not adequately address the threat.\(^{402}\)

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\(^{398}\) Articles 27(1) and 27(2) of Regulation (EU) No 236/2012.

\(^{399}\) Article 27(3) of Regulation (EU) No 236/2012.

\(^{400}\) Point (a) of article 28(2) of Regulation (EU) No 236/2012.

\(^{401}\) Article 24(3) of the Commission Delegated Regulation (EU) No 918/2012.

\(^{402}\) Article 28(2)(b) of Regulation (EU) No 236/2012.
2. Powers of the ESMA

The powers of the ESMA, within the conditions set out above, are very similar to those of the competent authorities.

2.1. The disclosure of net short positions

The ESMA may require anyone holding a net short position in relation to a specific instrument or class of financial instruments to disclose this position to a competent authority or to the market. ④⁰³

2.2. The restriction on short selling and similar transactions

The ESMA’s power to restrict or fully prohibit short selling or similar transactions in exceptional circumstances is identical to that of the competent authorities.

3. Request to reconsider

If the ESMA takes any of the aforementioned measures, the member state may request it to reconsider its decision. ④⁰⁴ In this case, the ESMA’s Board of Supervisors, which normally decides by simple majority, needs a qualified majority to follow through with the proposed measure.

4. Considerations by the ESMA in relation to the imposed measures

The European short selling regulation determines several considerations the ESMA has to take into account with regard to the measure it imposes. The ESMA must consider whether its emergency measure against short selling meets the following conditions:

(a) the measure significantly addresses the concerned threats or significantly improves the ability of the competent authority to monitor the threats;
(b) the measure does not create a risk of regulatory arbitrage;
(c) the measure does not have a detrimental effect on the efficiency of financial markets, such as the reduction of liquidity or the creation of uncertainty for market participants, that is disproportionate to the benefits of the measure. ④⁰⁵

In our opinion, the last condition may be problematic for the ESMA. If anything, the financial crisis of 2008 has proven that emergency measures against short selling are prone to cause damage to the economy.

④⁰³ Point (a) of article 28(1) of Regulation (EU) No 236/2012.
④⁰⁵ Article 28(3) of Regulation (EU) No 236/2012.
Although the European short selling regulation does not determine any sanctions in case of the violation of any of these conditions, these conditions may be of help when appealing to an emergency measure taken by the ESMA.

4. Procedure
Before deciding to impose or renew any emergency measure, besides requesting several obligatory consultations\(^406\), the ESMA must notify the competent authorities concerned. This notification includes details of the proposed measures, the class of financial instruments and transactions to which they apply, the evidence supporting the reasons for those measures and when the measures are intended to take effect.\(^407\) Subsequently, the ESMA will publish this decision on its website.\(^408\)

The ESMA is obligated to review the imposed measures at appropriate intervals and at least every three months.\(^409\)

5. Appeal
If the ESMA fails to take the abovementioned conditions in relation to the imposed measures into account, this may constitute a basis for appeal by any person or competent authority. The rules concerning the appeal by a competent authority or a natural or legal person are set out in article 60 of Regulation (EU) No 1095/2010. Given the urgency of the measures, the appeal procedure is too slow to be effective. Competent authorities who wish to take legal action against an emergency measure imposed by the ESMA, may have to wait two months for a decision by the Board of Appeal of the ESMA.\(^410\) If the Board of Appeal decides against the competent authority or person submitting the appeal, action can be taken before the Court of Justice of the European Union.\(^411\)

Section 3. The Greek and Italian emergency measures under the European short selling regulation
The Greek and Italian governments have already used the European legal framework for the imposition of emergency measures. On 1 November 2012, the day Regulation (EU) No 236/2012 went into force, the Greek HCMC (Hellenic Capital Market Commission) introduced

\(^406\) Article 28(4) of Regulation (EU) No 236/2012.
\(^407\) Article 28(5) of Regulation (EU) No 236/2012.
\(^408\) Article 28(6) of Regulation (EU) No 236/2012.
\(^409\) Article 28(10) of Regulation (EU) No 236/2012.
\(^410\) Article 60(2) of Regulation (EU) No 1095/2010.
Section 4. Evaluation of the European framework for emergency measures against short selling

The European short selling regulation succeeded in its objective to introduce transparency and consistency in relation to emergency measures against short selling by member states. Both Greece and Italy were able to introduce measures against short selling within the framework of the European regulation on short selling.

However, we have one important point of criticism. The financial crisis of 2008 has provided us with many examples of unsuccessful emergency regulations. These regulations are likely to have caused serious damage to the European economy. Preceded, we have emphasised the importance of self-evaluation by competent authorities during and after the imposition of emergency measures against short selling in order to overcome this problem. When using its powers to impose emergency measures, the ESMA is obligated to review these measures at appropriate intervals and at least every three months.

412 This ban was already in effect, but had to be re-introduced in compliance with the new European regulation on short selling.
418 Article 28(10) of Regulation (EU) No 236/2012.
authorities. These authorities only have to include evidence supporting the reasons for the imposition or renewal of emergency measures in their notifications to the ESMA.\textsuperscript{419} We believe that, by not obligating the competent authorities to evaluate their measures and do analyse their effects on the economy, the European legislator has failed to adequately avoid damaging emergency measures in the future.

This would not be a problem, however, if the ESMA would take it upon itself to thoroughly evaluate the effects of the emergency measures imposed by the competent authorities. As the ESMA has to issue an opinion in case of a renewal of such a measure, the ESMA certainly has the opportunity to do so. However, taking into account the opinions by the ESMA on the renewal of the Italian and Greek emergency measures, we believe the ESMA’s evaluation of the emergency measures is insufficient. In no way do the published opinions of the ESMA show any sign of research on the effects of the emergency measures on the economy.

Regulators in Europe seem to have drawn few lessons from the financial crisis of 2008. The European regulator demonstrates little restraint regarding the imposition of emergency measures against short selling. This is in sharp contrast with the US SEC, the chairman of which stating that “knowing what we know now, I believe on balance the commission would not do it [i.e. imposing a ban on short selling] again”.\textsuperscript{420} There is no reason to assume that during the financial crisis, the effects of the short selling ban in the US were more detrimental for the economy than those introduced in Europe.\textsuperscript{421} Yet, whereas the US SEC expressed its intention to refrain from making the same mistake again, emergency measures against short selling are still being taken in Europe, with a distressing lack of evaluation of the effects of these measures by the regulatory bodies imposing them.

\textbf{Section 5. Legal action by the UK against the powers delegated to the ESMA}

The UK objected to the wide amount of power the ESMA was given in taking emergency measures against short selling and, on 31 May 2012, initiated legal action against the European Parliament and the European Council, in accordance with article 263 TFEU.\textsuperscript{422} In its action, the

\textsuperscript{419} Article 26(2) of Regulation (EU) No 236/2012.
\textsuperscript{421} U.K. and N. Ir., CJEU Case C-270/12.
UK sought the annulment of article 28 of Regulation (EU) No 236/2012, which lists the intervention powers of the ESMA. The UK based the annulment of article 28 on four arguments:

1. article 28 of Regulation (EU) No 236/2012 constitutes a breach of the principles relating to the delegation of powers laid down in the case Meroni v High Authority;
2. article 28 constitutes a breach of the principle established in the Romano case;
3. article 28 is incompatible with articles 290 TFEU and 291 TFEU;
4. article 28 is incompatible with article 114 TFEU.423

In the following subsections, we will address these four arguments made by the UK. For each argument we will summarise the judgment of the European Court of Justice.

**Subsection 1. The alleged breach of the principles relating to the delegation of powers laid down in the Meroni doctrine**

1. **The Meroni doctrine**

   The Meroni doctrine, which arose from the European Court’s judgment in the case Meroni & Co., Industrie Metallurgiche, S.p.A. v High Authority of the European Coal and Steel Community of 13 June 1958, limits the ability of the institutions of the European Union to delegate powers to regulatory agencies. The essence of the Meroni doctrine is that the delegation of a discretionary power by an institution of the European Union to an agency causes the latter to be involved in policy-making when taking decisions based on the discretionary power concerned. The Court considers this to be incompatible with European Treaty-law. According to the Meroni doctrine, the delegation of powers can only relate to clearly defined executive powers. Furthermore, the delegating institution must supervise the agency concerned in the light of objective criteria.424

2. **The arguments of the UK and the judgment of the Court**

   The UK considered the delegation of powers to the ESMA by article 28 of Regulation (EU) No 236/2012 constituted a breach of the Meroni doctrine. The UK argued that the ESMA had a very large measure of discretion in considering whether the two criteria set out in article 28(2) of the Regulation were met. First of all, according to the UK, the determination by the ESMA of whether there is a threat in the sense of article 28(2) of

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423 As we will explain in subsection 4 of this section, this last argument only applied conditionally.
the Regulation is a highly subjective judgment. Furthermore, the UK stated that in determining whether a member state has adequately taken measures to address the concerned threat, the ESMA will be involved in the implementation of actual economic policy, which is in violation of the Meroni doctrine.

The UK argued that article 28(1) of the Regulation, which lists the measures the ESMA can impose, gives the ESMA many choices in determining the measures to be imposed and possible exemptions thereof. Furthermore, according to the UK, the considerations the ESMA has to take into account when taking these measures do not actually limit the powers of the ESMA, as the ESMA has a wide discretion in deciding how to evaluate these considerations. Moreover, the Regulation also fails to determine how the ESMA has to take the concerned considerations into account. If for example the ESMA considers a measure will have detrimental effects to the economy, it is not forbidden to impose the measure nonetheless. According to the UK, article 28(3) of the Regulation, which seems to limit the ESMA’s power, in fact gives the ESMA discretionary powers. Thus, even if the ESMA is not involved in actual policy-making, as argued in the paragraph above, article 28 of the Regulation is still in violation of the Meroni doctrine, as it delegates discretionary powers to the ESMA.

The Court did not follow the reasoning by the UK. The Court denied that the ESMA has a wide array of measures to choose from, as article 9(5) of Regulation (EU) No 1095/2010 limits the ESMA’s authority in doing so. Furthermore, the Court refutes that the ESMA has discretionary powers by referring to the abovementioned conditions and considerations to be taken into account by the ESMA, which, according to the Court, among other things, constitute a significant number of factors the ESMA must examine before taking a measure and therefore sufficiently limit the ESMA’s power.

Subsection 2. The alleged breach of the Romano doctrine

According to the Romano doctrine, the Council cannot delegate to agencies the power to adopt acts “having the force of law”. The UK, in our opinion legitimately, stated that article 28 of Regulation 236/2012 authorises the ESMA to adopt quasi-legislative measures of general application, which is a violation of the Romano doctrine. Although the Court agrees that the measures have a general application, it does not consider article 28 to constitute a breach of the

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Romano doctrine. Given the fact that articles 263 and 277 TFEU allow agencies to adopt acts of general application, the Court states that the Romano case does not impose conditions on the delegation other than those imposed following the Meroni case. Hereby, the Court seems to imply that the restrictions with regard to the delegation of powers set out in the Romano case have become irrelevant. Some find that by this judgment, the Court has introduced a new delegation doctrine in the EU, according to which European institutions can in fact delegate powers to take legally-binding decisions of general application to EU agencies.

Subsection 3. The alleged breach of articles 290 TFEU and 291 TFEU

Article 290 TFEU authorises the European Parliament and the Council to delegate the power to the Commission to adopt acts of general application and, together with article 291 TFEU, determines the conditions which have to be fulfilled in order to do so. The UK stated that on the basis of these provisions, the delegation of the concerned power to impose measures of general application to the ESMA, and thus not the Commission, are in violation of the Treaty on the Functioning of the European Union. The Court, however, stated that articles 291 and 292 TFEU do not prohibit the European Parliament and the Council to delegate powers of general application to other bodies than the European Commission.

Subsection 4. The alleged breach of article 114 TFEU

According to the UK, article 28 of the Regulation did not give the ESMA the power to take individual measures against natural or legal persons. Instead, it stated the powers delegated to the ESMA had a general application.

However, if according to the Court, the powers of the ESMA did not have a general application, the UK stated article 28 of the Regulation violated article 114 TFEU, as according to this article the European legislator does not have the authority to take individual measures that are not of general application, nor the authority to delegate such powers.

The Court stated that article 28 of the Regulation does empower the ESMA to take measures with a general application. Yet, according to the Court it cannot be ruled out that the ESMA


can also take decisions directed to individuals on the basis of this provision. The Court considered there was no breach of article 114 TFEU, however, as it considered the following conditions to be fulfilled:

- the delegating legislative act must comprise measures for the approximation of the provisions laid down by law, regulation or administrative action in the Member State;
- the delegating legislative act must have as its object the establishment and functioning of the internal market.

**Subsection 5. Conclusion**

As the Court refuted all arguments by the UK, it did not annul article 28 of Regulation (EU) No 236/2012. The Court’s judgment may be important with regard to the European rules concerning delegation of powers to agencies, as it may be considered to be a step forward toward legitimizing EU agencies and delegating important powers to them.\(^{428}\)

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Conclusion

Short sellers bring many benefits to the market. They increase price efficiency and liquidity and they serve as an important detection mechanism for fraud. Studies show that restrictions on short selling decrease price efficiency and liquidity and increase volatility. Therefore, it comes as no surprise to us that the emergency measures against short selling imposed across the world, in general seem to have caused more damage to the market than they were beneficial. This also applies to the emergency measures introduced in Belgium and the UK.

We observed that the Belgian measures against short selling during the financial crisis have had a smaller impact on liquidity than those introduced in the UK. We hypothesise that the fact that the Belgian measures against short selling were less severe may have caused this less negative impact. In Belgium, only naked short selling was prohibited, whereas in the UK holding a net short position was forbidden. This hypothesis is based on the assumption that, given the damage short selling restrictions cause to the economy, the damage caused to the economy is proportional to the severity of the restriction. We therefore expect the Belgian short sale restriction to also have had a smaller impact on price efficiency.

However, the abovementioned hypothesis only applies for the time during which both the UK and Belgian short selling prohibitions were in effect. In the UK, where the FCA subjected itself to rigorous self-evaluation, the regulator decided not to renew its ban on short selling, whereas in Belgium, the prohibition of naked short selling was made permanent and then changed into a prohibition of both naked and covered short selling. Therefore, in the long term, we suspect the Belgian short selling regulation to have caused more damage to the economy. In the light of all the studies pointing to the damage caused by short selling restrictions, we question the usefulness of these actions. We suggest that more rigorous self-evaluation, as conducted by the UK FCA, would prevent damaging regulation to stay in place or at least take away the uncertainty with regard to its effects.

Despite the seeming unanimity among scholars concerning the dangers of short sale restrictions and the fact that studies show that naked short selling, like covered short selling, is beneficial for the economy, in 2012, the European Union introduced a permanent ban on naked short selling. Furthermore, it installed a legal framework for member states to introduce additional measures against short selling in exceptional circumstances. During the financial crisis of 2008,
many member states, such as Belgium and the UK, lacked a suitable legal framework within which they could take emergency measures against short selling. By providing such a framework, the EU intended to create regulatory consistency and help member states react more effectively when confronted with exceptional circumstances. If member states, in the opinion of the European Securities Markets Authority (ESMA), fail to take adequate measures against short selling in such circumstances, the ESMA has the authority to impose these measures itself. The UK, which had previously (rightfully) shown restraint with regard to the imposition of anti-short selling measures, found that the delegation of this authority by the European legislator to the ESMA constituted a violation of European doctrine and treaty law and initiated a legal action. However, on 22 January 2014, The European Court of Justice rejected the arguments of the UK.

We share the UK’s concern with regard to the lack of restraint shown by the European Union in taking emergency measures against short selling. If anything, history has taught us that caution is in order when imposing such measures. Both in Greece and Italy emergency measures against short selling have been imposed within the legal framework provided by the European short selling regulation. An analysis of the notices given by the competent authorities of Greece and Italy to the ESMA and the opinions on the renewal of the emergency measures written by the ESMA, raise the suspicion that little lessons have been drawn from the results of the studies on the impact of anti-short selling measures on the economy. Neither of these documents show that the ESMA or the Italian or Greek competent authorities have conducted thorough research on the effects of the measures they imposed.

Taking into account the lack of restraint shown by the European Union with regard to the imposition of emergency measures against short selling, we estimate that if a financial crisis were to hit Europe again, similar mistakes will be made. This time, however, member states will have a suitable legal framework in which to do so.
## Annex – overview of the emergency measures against short selling during the financial crisis

<table>
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<tr>
<th>Country</th>
<th>Ban?</th>
<th>Scope of ban</th>
<th>Ban start date</th>
<th>Disclosure?</th>
<th>Scope</th>
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Legislation

Belgian legislation

Koninklijk Besluit van 23 september 2008 tot vaststelling van bepaalde handelingen die marktmisbruik uitmaken [translation: Royal Decree of 23 September 2008 on certain operations constituting market abuse].

Ministerieel Besluit van 19 december 2008 tot verlenging van de gelding van het koninklijk besluit van 23 september 2008 tot vaststelling van bepaalde handelingen die marktmisbruik uitmaken [translation: Ministerial decree of 19 December 2008 extending the application of the Royal Decree of 23 September 2008 on certain operations constituting market abuse].

Ministerieel besluit van 17 maart 2009 tot verlenging van de gelding van het koninklijk besluit van 23 september 2008 tot vaststelling van bepaalde handelingen die marktmisbruik uitmaken [translation: Ministerial decree of 17 March 2009 extending the application of the Royal Decree of 23 September 2008 on certain operations constituting market abuse].

Ministerieel besluit van 18 mei 2009 tot verlenging van de gelding van het koninklijk besluit van 23 september 2008 tot vaststelling van bepaalde handelingen die marktmisbruik uitmaken [translation: Ministeral decree of 18 May 2009 extending the application of the Royal Decree of 23 September 2008 on certain operations constituting market abuse].


Wet van 2 augustus 2002 betreffende het toezicht op de financiële sector en de financiële diensten [translation: Law of 2 August 2002 on the supervision of the financial sector and the financial services].

Wet van 30 juli 2013 tot versterking van de bescherming van de afnemers van financiële producten en diensten alsook van de bevoegdheden van de Autoriteit voor Financiële Diensten en Markten en houdende diverse bepalingen [translation: Law of 30 July 2013 enhancing the
protection of consumers of financial products and services and the authorities of the Financial Services and Markets Authority].


CBFA, “Q&A about new short selling rules announced by the CBFA (update)”, www.cbfa.be, 28 May 2009, A.6. (This Q&A is now removed from the FSMA’s website. In the article “The Prohibition of Short Selling. The Belgian Regulation and European Developments” by BOGAERT, much of the content of the concerned Q&A is documented.)


UK legislation

Financial Services Act 2010.


Financial Conduct Authority Handbook:

- Decision Procedure and Penalties Manual (DEPP);
- Financial Stability and Market Confidence Sourcebook (FINMAR);
- Glossary;
- Market Conduct Sourcebook (MAR);
  - Code of Market Conduct (MAR 1);
- Supervision Sourcebook (SUP).


FSA 2008/60, “Short Selling (No 4) Instrument 2008”

FSA 2009/1, “Short Selling (No 5) Instrument 2009”.


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European legislation


Commission Implementing Regulation (EU) No 827/2012 of 29 June 2012 laying down implementing technical standards with regard to the means for public disclosure of net position in shares, the format of the information to be provided to the European Securities and Markets Authority in relation to net short positions, the types of agreements, arrangements and measures to adequately ensure that shares or sovereign debt instruments are available for settlement and the dates and period for the determination of the principal venue for a share according to Regulation (EU) No 236/2012 of the European Parliament and of the Council on short selling and certain aspects of credit default swaps. (Regulation (EU) No 827/2012).


**Official press releases or reports**

**Belgium**


**UK**


**European Union**


Miscellaneous


Jurisdiction

ECJ 22 January 2014, C-270/12, United Kingdom v Parliament and Council.

ECJ 14 May 1981, C-98/80, Giuseppe Romano v Institut national d'assurance maladie-invalidité.


Academic literature

Books


**Contributions in journals and working papers**


**Online sources**


Articles in newspapers


Naar aanleiding van het faillissement van Lehman Brothers in september 2008 werden over de hele wereld maatregelen genomen tegen *short selling*. In deze thesis onderzoeken we de regulering van short selling tijdens en na de financiële crisis in België, het Verenigd Koninkrijk en de Europese Unie.

Deze thesis bestaat uit vier titels. Onder de eerste titel wordt een inleiding tot short selling gegeven. Onder deze titel geven we een definitie van short selling en leggen we het verschil uit tussen *covered* en *naked* short selling. Vervolgens geven we een overzicht van de verschillende soorten *short sellers* en hun motieven.

In het tweede deel van deze thesis behandelen we de mogelijke motiveringen voor het aan banden leggen van short selling en de wenselijkheid hiervan. Hiervoor worden de niet-juridische aspecten van short selling grondig onderzocht. Er wordt veel belang gehecht aan de impact op de economie van zowel short selling als het aan banden leggen ervan. Daarnaast wordt ook een ethische analyse van short selling uitgevoerd.


Onder de vierde en laatste titel van deze masterproef behandelen we regulering van short selling die in 2012 door de Europese Unie werd ingevoerd. Enerzijds legt zij een permanente beperking van short selling en een bekendmakingsplicht op, anderzijds biedt zij lidstaten een juridisch kader voor het nemen van verdere maatregelen tegen short selling in uitzonderlijke omstandigheden. Beide aspecten van deze regulering worden onderzocht.