RECONSTRUCTING SHORT SELLING REGULATORY REGIMES

TYLER A. O'REILLY†

Table of Contents

I. INTRODUCTION

This past May, the Dow Jones Industrial Average reached its highest peak in its 117-year history.[1] It is perhaps the starkest indication yet that the American economy is rebounding steadily from the throes of the financial crisis. The hopeful signs of improvement in the United States contrast sharply with the bleak economic prospects of Europe, where a collection of fragile national economies are widely expected to pose a stern threat to the world economy for the remainder of the decade.[2]

---

† Corporate Associate, Cahill Gordon & Reindel LLP, New York. B.A., 2010, *summa cum laude*, Assumption College; J.D., 2013, *magna cum laude*, Brooklyn Law School. The author's primary practice focus is leveraged finance, and he may be contacted at tyler.a.oreilly@gmail.com. I would like to thank Professor Roberta S. Karmel of Brooklyn Law School for her advice and thoughtful contributions that proved invaluable in the development of this article. I also gratefully acknowledge the assistance of the *Wayne Law Review* during the editorial process. I lastly owe a special thanks to my wife, Denise, for her endless encouragement and for inspiring me each day.

1. Jonathan Cheng, *U.S. Stocks Break More Records as DJIA Surpasses 15,000*, WALL ST. J. (May 7, 2013, 4:13 PM), http://online.wsj.com/article/BT-CO-20130507-714664.html.

2. Suzanne Daley, *Europe's Debt Crisis: No Relief on the Horizon*, N.Y. TIMES, http://www.nytimes.com/interactive/2012/12/30/world/europe/eurocrisis-photos.html?ref=europeansovereigndebtcrisis&_r=0 (last visited Sept. 26, 2013).

This widening chasm has set the stage for a vehement debate on the legacy of the regulatory responses to the global financial crisis and the ongoing sovereign debt crisis. A focal point of this discourse is certain to be the short selling ban, a temporary trading restraint that has reemerged in recent years as the weapon of choice among financial regulators in responding to acute economic instability. While it is beyond dispute that short selling enhances market welfare in significant ways, for example, by facilitating risk management operations and increasing market liquidity, these bans reflect the judgment that short selling may exert artificial downward pressure on stock prices and exacerbate market volatility during a crisis.[3]

This reawakened distrust of short selling is striking and stretches globally. In 2008, the United States Securities and Exchange Commission (SEC or Commission) introduced a series of temporary orders restricting various forms of short selling that, regulatory officials contend, threatened to exacerbate financial turmoil and erode investor confidence.[4] Faced with the onset of a severe global contraction, European regulators imposed comparable bans on short selling rooted in the same fundamental concern.[5] Three years later, oversight officials across Europe reinstated these measures on a sporadic basis to restore confidence in the integrity of a still-beleaguered economy stumbling through a fierce sovereign debt crisis.[6] More recently, a regulation passed by the European Parliament and the Council of the European Union, which entered into force on November 1, 2012, set forth a harmonized framework for the regulation of the short sale to supersede the patchwork of measures enacted by the disconnected Member States.[7]

While the recurring use of the ban implies that it carries significant value in combatting financial turbulence, the ban's utility in that pursuit remains tirelessly debated. In general, regulators and policymakers emphatically champion the short selling ban as an effective tool to stabilize the markets because, they say, unbridled short sales propel stock prices to artificially low levels and aggravate economic downturns unnecessarily.[8] Their opponents summarily dismiss this allegation and

3. Robert Battalio et al., Fed. Res. Bank of N.Y., *Market Declines: What is Accomplished by Banning Short-Selling?*, 18 CURRENT ISSUES ECON. & FIN. no. 5, 2012, http://www.newyorkfed.org/research/current_issues/ci18-5.pdf.

4. *See infra* Part II.B.

5. *See infra* Part IV.

6. *See infra* Part IV.

7. *See infra* Part IV.

8. Steven Russolillo, *Short Selling Bans Don't Work. Period.*, WALL ST. J. (Aug. 30, 2012, 11:48 AM), http://blogs.wsj.com/marketbeat/2012/08/30/short-selling-bans-dont-work-period/.

assert that, in fact, prior bans on short selling have demonstrated little success in slowing price declines in financial securities.[9]

It is not the intent of this article to enter this well-tread debate or express an opinion on the merits of the short selling ban. Rather, this article proceeds on the uncontested notion that regardless of the wisdom of employing this trading constraint in the first instance, a short selling ban—once instituted—should be founded in sound policy. In this regard, the existing regimes of the United States and the European Union suffer critical shortcomings.

First, as to the regulatory framework in the United States, the short selling ban is largely undermined when trading in derivatives is freely available. The primary purpose of a ban on short selling is to limit the ability of market participants to establish short positions that are detrimental to enduring economic stability. Certain widely accessible derivative products, however, enable investors to replicate the economic position established through short selling without limitation. These alternative avenues for "going short" are problematic. A short selling regulatory regime must not allow financial market participants to readily circumvent its restrictions through alternative trading instruments that are functionally indistinguishable but do not fall within the narrow confines of the order. As a practical matter, however, the SEC's past measures embody that precise flaw.

This article strives to rectify that limitation by urging greater cooperation between the SEC and the United States Commodity Futures Trading Commission (CFTC), the federal agency tasked with overseeing trading in derivatives, with the goal of redefining the perimeters of the ban to encompass derivatives. This proposed regulatory scheme would better reflect the reality that, from an economic frame of reference, harmful short positions in financial instruments may arise from transactions other than mere short selling.

Further, with respect to short selling regulation in Europe, the recent European Union (EU) legislation aiming to harmonize the detached regulatory regimes of the member states is inadequate because it affords national regulators too much latitude to deviate from its prescribed guidelines. Perhaps the most astonishing element of this regulation is that it vanquishes—without explanation—all preexisting restraints on

9. *See, e.g.*, Battalio et al., *supra* note 3; *see also* Russolillo, *supra* note 8; Michelle Price, *Short-Selling Bans 'Do More Harm than Good,'* FIN. NEWS (Oct. 4, 2011), http://www.efinancialnews.com/story/2011-10-04/short-sell-ban-ineffective; Gillian Tett, *Don't Be Fooled By Short-Selling Bans*, FIN. TIMES (Aug. 23, 2012, 8:53 PM), http://www.ft.com/intl/cms/s/0/ff1b8f5e-ed30-11e1-83d1-00144feab49a.html#axzz2NWYH2cqd.

covered short selling. Of particular significance is an exception that nevertheless allows national regulators to impose restrictions on this practice when "exceptional circumstances" warrant.[10]

While admittedly designed for infrequent use, a plain reading of this provision reveals that, in light of the ongoing crisis, this "exceptional circumstances" allowance is exceedingly broad and invites a return to the same asymmetric and uncoordinated regulatory scheme that prompted the EU response in the first place. To salvage aspirations of a coordinated European framework, this article petitions the European Securities and Markets Authority (ESMA), in the exercise of its facilitative role under the legislation, to establish standards ensuring that future pronouncements on covered short selling develop uniformly across member state lines.

Part II of this article provides an overview of short selling and delineates the theoretical underpinnings of the short selling ban during periods of market stress. Part II also explains the adverse consequences associated with the short selling ban which indicate that this emergency measure might actually be counterproductive if the professed benefits do not accrue to the markets. To ensure that this does not occur, Part III calls for greater coordination between the SEC and the CFTC in order to regulate certain derivative contracts that stand to undermine the objectives of the trading ban. Part IV shifts focus to the European Union. It begins by detailing the European Union's recent legislative efforts to harmonize the current fragmented approaches to short selling regulation among the member states. It then challenges the practical likelihood that such harmonization will occur, at least with respect to covered short selling, in light of a vast "exceptional circumstances" clause that sanctions a swift departure from the prescribed standards of the regulation. A brief conclusion follows.

II. FOCUS AND DRAWBACKS OF THE SHORT SELLING BAN

The propriety of short selling has long been a contentious and deeply politicized issue.[11] Many critics take a hard line on this form of trading, cascading it with denunciatory invectives.[12] A simple explanation for

10. *See infra* Part IV.

11. *See* Michael D. McKenzie, *Should Short Selling Be Banned During Period of Market Turmoil?*, JASSA, no. 2, July 1, 2012, at 8, *available at* http://www.readperiodicals.com/201207/2722840501.html#b; Roberta S. Karmel, *IOSCO's Response to the Financial Crisis*, 37 J. CORP. L. 849, 874 (2012).

12. One detractor colorfully likened short sellers to "bank robbers and asset strippers." James Mackintosh, *Short Shrift*, FIN. TIMES (Oct. 5, 2008, 6:37 PM), http://www.ft.com/intl/cms/s/0/f8328a36-92fc-11dd-98b5-0000779fd18c.html#axzz2DZa

why this is so and "why short selling has never won any popularity contests" is that "the short seller profits from other people's mistakes."[13] But aside from pulling on the moral fabric of market participants, observers, and regulators alike, pessimistic short selling has also been condemned since at least the New Deal era for compromising market integrity and derailing economic recovery.[14] The short seller has received an exceptional degree of regulatory circumspection in recent years, due in large part to a languishing economy still struggling to emerge from the worst financial crisis since the Great Depression and a debilitating sovereign debt crisis in Europe.

This Part briefly summarizes short selling and explains why the practice has become a lightning rod for scrutiny; demonstrates the propensity of regulators to brandish from their repertoire the emergency short selling ban in an attempt to revivify the integrity of, and reestablish the public's trust in, the financial markets; and examines the unintended negative consequences of the short selling ban on market efficiency.

A. An Overview of Short Selling

The short sale is one of a number of common trading strategies employed by investors to engineer specific investment objectives.[15]

---

tDiSQ. Others similarly condemn the practice of "profiting from falling [stock] prices as morally lamentable." Piero Cinquegrana, *Short Selling: A Known Unknown*, EUR. CAP. MARKETS INST. 3 (May 2009), http://aei.pitt.edu/11447/1/1849.pdf.

13. Stephen Kirchner, *Shooting the Messenger: The Political Economy of Short Selling*, *in* SHOOTING THE MESSENGER: THE BAN ON SHORT SELLING 3, 5 (Stephen Kirchner ed., 2010), *available at* http://www.institutional-economics.com/images/uploads/ PF19.pdf.

14. *See* Kay A. Gordon, *Regulation of Short Selling in the U.S.*, REV. OF SEC. & COMMODITIES REG., July 21, 2010, at 179. Emphasizing the long-standing condemnation of short selling, Gordon notes prior castigation from the executive branch:

> President Hoover is said to have been convinced that the stock market situation was primarily due to the bear raids of short sellers, who were canceling out his measures for halting the panic, and in March 1932[,] the Senate passed a resolution calling for an investigation of bear raids by its Banking and Currency Committee. Nor was Hoover alone. It is of more than passing interest, the journalist John Flynn observed at the time, that the blaze of popular wrath against the Exchange flamed up not when people found themselves stripped of their life's savings in the disorderly declines of 1929 and 1930, but later in 1931 when the notion got out that the decline was the work of a group of wicked bear raiders—professional speculators—who by selling short were driving prices lower and preventing recovery.

Id. at 182 n.24.

15. *See* *Investment Objectives*, LONDON STOCK EXCHANGE, http://www.londonstockexchange.com/traders-and-brokers/private-investors/private-

Investors attracted by the long-term growth potential of particular stocks may choose to "buy and hold" the securities for an extended period without regard to short-term developments, seeking to outsmart the markets and profit on attendant capital appreciation.[16] Others may purchase and sell shares with greater frequency in an effort to capitalize in the near-term on quotidian shifts in securities prices.[17] Still others utilize the short sale to gamble that the price of a particular asset will decline in value.[18]

The SEC defines a short sale as "any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller."[19] In basic terms, the mechanics of the short selling process first involve an investor borrowing securities from a broker or institutional investor on the condition that those securities will be replaced at a future date.[20] Next, the investor sells these borrowed shares on the market with the expectation that the securities will decline in value.[21] Finally, after probing the market for the expected price reduction, the short seller

---

investors/about-share/investment-objectives/investment-objectives.htm (last visited Oct. 20, 2012).

16. *Id.*

17. *Id.*

18. *Id.*

19. 17 C.F.R. § 242.200(a) (2010).

> A person shall be deemed to own a security if:
>
> (1) The person or his agent has title to it; or
>
> (2) The person has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it, but has not yet received it; or
>
> (3) The person owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or
>
> (4) The person has an option to purchase or acquire it and has exercised such option; or
>
> (5) The person has rights or warrants to subscribe to it and has exercised such rights or warrants; or
>
> (6) The person holds a security futures contract to purchase it and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security.

Id. § 242.200(b)(1)-(6). The statute further provides that "a person shall be deemed to own securities only to the extent that he has a net long position in such securities." *Id.* § 242.200(c).

20. *See* Scott Rothbort, *How Short Selling Works*, Street (Oct. 8, 2007, 8:14 PM), http://www.thestreet.com/story/10383365/1/how-short-selling-works.html.

21. *Id.*

purchases equivalent shares at the lower price and delivers them to the lender as repayment.[22]

If the anticipated price decline materializes before repurchase, the proceeds from borrowing will exceed the costs of borrowing, inclusive of lending fees and transaction costs, and the short seller profits by "pocketing the difference."[23] While the gains from this practice are appreciable,[24] so too are the losses: "Short sellers are exposed to great risks because theoretically the market price of the security or asset sold short can rise without limit," thus compelling the short seller to repurchase the securities at a price far higher than the price at which the shares were initially sold.[25]

An earlier rule established by the SEC prevented a trader from affecting a short sale of an exchange-listed security at a lower price than that at which the immediately preceding trade was executed.[26] This rule—formally named Rule 10a-1 but known colloquially as the "uptick" rule—was adopted in 1938 to eliminate speculative attacks in falling markets "by allowing a stock to be sold short only after a rise (an 'uptick') from its immediately prior price."[27] The SEC repealed this trading restriction on July 3, 2007 based primarily on the results of a pilot program which suggested that the short sale price test "had become unnecessary with decimal pricing and the transparency and surveillance in exchange markets."[28] Much of the skepticism surrounding the uptick rule was also attributed to the "widespread availability" of derivative products.[29]

22. *Id.*

23. Russolillo, *supra* note 8.

24. Helena Stigmark, *Should Short Selling Be Regulated as a Consequence of Wall Street's Failures? Exploring the New Alternative Uptick Rule*, MICH. BUS. L.J., Fall 2010, at 32, *available at* https://michbar.org/business/BLJ/Fall%202010/stigmark.pdf. Note, however, that profit from short selling has a ceiling. An investor's return from going short "can never be greater than 100 percent minus fees," which only takes place in the rare "event that the market price falls to zero." *Id.*

25. *Id.*; *see* Russolillo, *infra* note 90.

26. Kara Scannell, *SEC May Reconsider 'Uptick Rule,'* WALL ST. J. (Mar. 10, 2009, 9:27 PM), http://online.wsj.com/article/SB123670796893885821.html.

27. Robert C. Pozen & Yaneer Bar-Yam, *There's a Better Way to Prevent 'Bear Raids,'* WALL ST. J. (Nov. 18, 2008), http://online.wsj.com/article/SB122697410070336091.html; *see* Regulation SHO and Rule 10a-1, Exchange Act Release No. 55,970, 72 Fed. Reg. 36,348 (July 3, 2007) (to be codified at 17 C.F.R. pt. 240, 241).

28. Karmel, *supra* note 11, at 875.

29. *Id.*

Following the financial cataclysm of 2008, a common refrain has called for the SEC to restore the uptick rule.[30] While declining to acquiesce to the request, the SEC has appeased these advocates in part by imposing temporary restrictions on short selling in periods of extreme market volatility during which financial institutions are particularly vulnerable to speculative attack.[31] The Commission has even gone so far as to outlaw naked short selling completely.[32]

Despite the negative connotations, the short sale is not a "prima facie evil" investment tool.[33] To the contrary, short selling plays a critical role in capital markets and is "generally endorsed for its positive effects on securities markets."[34] For instance, short sellers are lauded for performing valuable social functions that enhance market welfare, such as contributing to price discovery and market liquidity.[35] Further, it has become an extremely common hedging strategy to protect against the downside risk associated with a particular long position.[36] Nevertheless, these virtues are largely overshadowed during times of market turmoil, as regulators focus principally on the capacity of short selling to place

30. *See, e.g.*, Stigmark, *supra* note 24; Charles R. Schwab, *Restore the Uptick Rule, Restore Confidence*, WALL ST. J. (Dec. 9, 2008), http://online.wsj.com/article/SB122878208553589809.html.

31. *See infra* Part II.B; Schwab, *supra* note 30. Unlike the temporary emergency measures, the reinstatement of the uptick rule raises a newfound concern about whether this rule could withstand judicial review. The United States Court of Appeals for the District of Columbia Circuit "has earned a reputation for rigorous review of agency action" and has demonstrated a readiness to scrutinize with precision the SEC's analysis of the economic consequences of a rule as required by Section 3(f) of the Securities Exchange Act of 1934 and Section 2(c) of the Investment Company Act of 1940. *D.C. Circuit Finds SEC Proxy Access Rule Arbitrary and Capricious for Inadequate Economic Analysis*, 125 HARV. L. REV. 1088, 1094 (2012). This enhanced judicial scrutiny was exemplified most recently in *Business Roundtable v. S.E.C.*, in which the court, in a scathing opinion written by Judge Douglas Ginsburg, struck down the SEC's Rule 14a-11 on proxy access for failing to adequately consider the rule's "effect upon efficiency, competition, and capital formation." 647 F.3d 1144, 1146 (D.C. Cir. 2011).

32. Amendments to Regulation SHO, Exchange Act Release No. 60,388, 74 Fed. Reg. 38,266 (July 31, 2009) (to be codified at 17 C.F.R. pt. 200, 242).

33. John M. Green, *ASIC Should Extend its Short Selling Ban, Not End It, in* SHOOTING THE MESSENGER: THE BAN ON SHORT SELLING 23, 24 (Stephen Kirchner ed., 2010), *available at* http://www.institutional-economics.com/images/uploads/PF19.pdf.

34. Richard E. Ramirez, *Falling Short: Has the SEC's Quest to Control Market Manipulation and Abusive Short-Selling Come to an End, or Has It Really Just Begun?*, 2 U. P.R. BUS. L.J. 76, 79 (2011); *see* TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, REGULATION OF SHORT SELLING: CONSULTATION REPORT 6 (2009) [hereinafter IOSCO CONSULTATION REPORT], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf.

35. *See infra* Part II.C.

36. *See id.*; Stigmark, *supra* note 24, at 32.

downward pressure on stock prices and undermine the integrity of both financial institutions and the greater economic system.[37]

B. Short Selling Regulation, in Context

By March 2008, investor confidence in the American financial markets had plummeted into a downward spiral.[38] While catastrophe had been narrowly averted with JP Morgan's publicly-financed acquisition of embattled investment bank Bear Stearns, uncertainty and fear lingered well into the summer months.[39] In this volatile economic climate, the SEC viewed short selling with considerable trepidation. It specifically feared—reminiscent of the principal justification for the uptick rule—that unhindered short selling would prompt speculative attacks and baseless price declines.[40]

The SEC was particularly concerned with bear raids, occurring when an equity security was sold short in an effort to drive down its price by creating an imbalance of sell-side interest. The Commission believed that this unrestricted short selling could further dampen an already declining market by increasing pressure from the sell-side, eliminating bids, and creating an appearance that prices were falling for fundamental reasons, when the decline, or the speed of the decline, was being driven by other factors.[41]

To prevent further market degradation in this manner, the SEC introduced an emergency measure on July 15, 2008 (the July Emergency Order) pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934, which "grants the Commission the authority, in the event of certain major market disturbances, to issue summarily orders to alter, supplement, suspend, or impose requirements or restrictions with respect to matters or actions subject to regulation by the Commission."[42] This interim order, set to expire after two weeks, imposed an outright

37. *See* U.S. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 292-93 (2011) [hereinafter FINANCIAL CRISIS INQUIRY REPORT], *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

38. *Id.*

39. Gordon, *supra* note 14, at 181.

40. *Id.*

41. Emergency Order, Exchange Act Release No. 58,166, 93 SEC Docket 2122 (July 15, 2008) [hereinafter *July Emergency Order*]; *see* Press Release, SEC, SEC Enhances Investor Protections Against Naked Short Selling (July 15, 2008), http://www.sec.gov/news/press/2008/2008-143.htm.

42. Emergency Order, Exchange Act Release No. 44,791 (Sept. 14, 2001); *July Emergency Order*, *supra* note 41.

prohibition on the "naked" short selling of the securities of nineteen financial institutions, including American International Group, Merrill Lynch, and Lehman Brothers Holdings.[43] According to the Commission, the prevailing state of financial affairs had given rise to "a substantial threat of sudden and excessive fluctuations of securities prices generally and disruption in the functioning of the securities markets that could threaten fair and orderly markets."[44] It further stated that naked short selling—a perverse variation of short selling through which the investor, rather than borrowing the securities sold, sells shares it neither owns nor borrows—had the potential to contribute to disorderly markets by accelerating and magnifying the unjustified downward pressure on securities prices.[45] In support of this action, the SEC cited the Bear Stearns catastrophe to illustrate the broad systemic concerns posed by speculative attacks.[46]

Despite the enhanced SEC oversight, this emergency measure had little success in stabilizing the equity markets.[47] This was largely because the long-term viability of another major Wall Street investment bank was quickly brought into question. Shortly after the collapse of Bear Stearns in March, regulators prophetically identified Lehman Brothers "as the next big worry among the four remaining large investment banks."[48] By virtually all accounts, it was no longer "a matter of *whether* Lehman would fail, but *when*."[49] The answer ultimately came in the early morning hours of Monday, September 15, 2008, as Lehman filed for bankruptcy in a move that ignited a ripple effect of pandemonium throughout Wall Street and the global financial system.[50]

---

43. *July Emergency Order*, *supra* note 41.
44. *Id.*
45. *Id.*
46. *Id.*
47. FINANCIAL CRISIS INQUIRY REPORT, *supra* note 37, at 325.
48. *Id.*
49. *Id.*
50. Peg Brickley, *Lehman Makes It Official in Overnight Chapter 11 Filing*, WALL ST. J. BLOG (Sept. 15, 2008, 7:40 AM), http://blogs.wsj.com/wallstreetcrisis/2008/09/15/lehman-makes-it-official/. Over a year after the collapse of Lehman, the Chairman of the Federal Reserve explained to the Financial Crisis Inquiry Commission that regulatory officials understood the havoc that a Lehman bankruptcy would wreak on the financial system:

> We never had any doubt about that. It was going to have huge impacts on funding markets. It would create a huge loss of confidence in other financial firms. It would create pressure on Merrill and Morgan Stanley, if not Goldman, which it eventually did. It would probably bring the short-term money markets into crisis, which we didn't fully anticipate; but, of course, in the end it did bring the commercial paper market and the money market mutual funds under pressure. So there was never any

Faced with yet another blow to investor confidence, the SEC announced second and third emergency orders on September 17 and September 18, respectively (together, the September Emergency Orders).[51] Issued just days after the Lehman bankruptcy, these measures collectively prohibited all persons from affecting a short sale in the securities of 799 U.S.-based financial institutions and financial companies.[52] Notwithstanding the wider reach, the central object remained the same: to mitigate volatility in the financial markets and forestall unjustified downshifts in stock prices.[53] In the September Emergency Orders, the SEC reiterated that, in an ailing market like the one dawning in 2008, unbridled short selling can imperil the fair and orderly operation of the securities markets by depressing stock prices suddenly and in a manner wholly inconsistent with intrinsic value.[54]

There are good reasons for why the SEC sought to avoid artificial downward price shifts. The most important among them relates to the negative signal that this fluctuation transmits to the market concerning the financial health of the underlying institution. This signal—whether rooted in legitimate concerns or attributable to the baseless speculation of short sellers—further deteriorates investor confidence in the institution and can ultimately engender broad systemic damage.[55] The Bear Stearns

---

> doubt in our minds that it would be a calamity, catastrophe and that, you know, we should do everything we could to save it.

FINANCIAL CRISIS INQUIRY REPORT, *supra* note 37, at 339.

51. Emergency Order, Exchange Act Release No. 58,572 (Sept. 17, 2008) [hereinafter *September 17 Emergency Order*]; Emergency Order, Exchange Act Release No. 58,592, 94 SEC Docket 460 (Sept. 18, 2008) [hereinafter *September 18 Emergency Order*].

52. *See September 17 Emergency Order*, *supra* note 51; *September 18 Emergency Order*, *supra* note 51; Amendment to Emergency Order, Exchange Act Release No. 58,611, 94 SEC Docket 501 (Sept. 21, 2008). This number ultimately climbed to nearly 1000 stocks, as the various national exchanges sought heightened protection for vulnerable entities. Mackintosh, *supra* note 12. Included on this list were the shares of International Business Machines Corp., General Motors Corp., and General Electric Corp., as well as other operating companies that "may not be the most obvious firms to be picked out as financials." Ruth Mantell, *Short-Sale Ban List Expanded to Include GE, GM*, MARKETWATCH (Sept. 22, 2008), http://articles.marketwatch.com/2008-09-22/news/30759943_1_financial-corp-allied-capital-corp-ban-list. The stock of these corporations was nevertheless included on this "no short" list because each operates a financial arm whose operations account for a significant portion of revenue. *Id.*

53. *September 18 Emergency Order*, *supra* note 51.

54. *Id.*

55. *Id.* "Public trust and confidence is the bedrock of our financial system, the core asset underlying why our financial markets are the envy of the world." WILLIAM H. MANZ, CORPORATE FRAUD RESPONSIBILITY: A LEGISLATIVE HISTORY ON THE SARBANES-OXLEY ACT OF 2002, at 185 (2003). This recognition forms the basis of the SEC's intervention:

debacle, which resulted from a considerable write-down of the firm's mortgage-related assets, authoritatively captures the magnitude of a crisis of confidence in a financial institution:

> [The asset write-down] prompted investors to scrutinize Bear Stearns's finances. Over the fall, Bear's repo lenders—mostly money market mutual funds—increasingly required Bear to post more collateral and pay higher interest rates. Then, in just one week in March 2008, a run by these lenders, hedge fund customers, and derivatives counterparties led to Bear's having to be taken over in a government-backed rescue.[56]

Elisse Walter, a Commissioner and former Chairman of the SEC, once aptly observed: "It can take years to build up trust, and only seconds to destroy it."[57] The SEC's approach to short selling regulation strongly reflects this articulation. With the Bear Stearns calamity providing a keen reminder of the consequences of such a precipitous contraction of investor confidence, the SEC invoked the short selling ban to prevent short sellers from propelling securities prices downward and dispatching negative signals that could expose financial institutions to unmanageable losses.[58]

C. *The Unintended Negative Consequences of Short Selling Bans*

Notwithstanding these considerations and the clear benefit of preempting baseless price movements, the financial markets are

---

> Given the importance of confidence in our financial markets as a whole, we have become concerned about recent sudden declines in the prices of a wide range of securities. Such price declines can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence, without a fundamental underlying basis. This crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences.

September 18 Emergency Order, *supra* note 51.

56. FINANCIAL CRISIS INQUIRY REPORT, *supra* note 37, at 280.

57. Elisse B. Walter, Commissioner, U.S. Sec. & Exch. Comm'n, Remarks Before the Practicing Law Institute: Restoring Investor Trust Through Corporate Governance (Feb. 18, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch021809ebw.htm).

58. Robust public criticism led former SEC Chairman Christopher Cox to concede, just two months after the September short selling bans expired, that supporting the measure in September was "the biggest mistake of his tenure." Amit R. Paley & David S. Hilzenrath, *SEC Chair Defends His Restraint During Financial Crisis*, WASH. POST (Dec. 24, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/12/23/AR2008122302765.html.

doubtlessly impaired in certain key respects with the imposition of short selling bans.

The first among these drawbacks relates to price discovery.[59] This refers to the process, frequently touted as "one of the central functions of financial markets," by which the market determines the appropriate price of an asset according to supply and demand.[60] The defining characteristic of this efficient price discovery process is the market's ability to rapidly digest new information about a security's fundamental value into the asset price as it becomes available.[61] Notably, the market's "search for an equilibrium price" is materially enhanced when short selling is unencumbered.[62] This is rooted in the fact that short sellers have a powerful financial incentive to identify overpriced stocks and to trade in a manner that drives the price downward to a level that more accurately reflects fundamental value.[63] Many economists, including Milton Friedman, certify the valuable service that short sellers provide to the market through this equilibrium-seeking activity.[64] Even the SEC

59. Richard C. Green, Dan Li & Norman Schurhoff, *Price Discovery in Illiquid Markets* (Apr. 25, 2008), http://www.cereg.dauphine.fr/UserFiles/File/WFMQ2008_2.pdf.

60. *Id.*; Bingcheng Yan & Eric Zivot, *The Dynamics of Price Discovery* (Feb. 26, 2007), http://faculty.washington.edu/ezivot/research/dynamicsOfPriceDiscovery.pdf.

61. Yan & Zivot, *supra* note 60, at 9-10 ("A market is more efficient in the price discovery process than another market if it incorporates a larger amount of new information more quickly.").

62. *Id.* at 1; IOSCO CONSULTATION REPORT, *supra* note 34, at 22.

63. Yan & Zivot, *supra* note 60, at 1; *see* Ekkehart Boehmer & Julie Wu, *Short Selling and the Price Discovery Process*, EDHEC-RISK INST. (May 2010), http://faculty-research.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=1328885973952.

64. *See, e.g.*, MILTON FRIEDMAN, THE OPTIMUM QUANTITY OF MONEY 285 (2009); Battalio et al., *supra* note 3, at 2. In demonstrating the positive effects of short selling on price discovery, economists at the Federal Reserve Bank of New York advert to the speculative yet informed activity of James Chanos. In his testimony before Congress, Chanos, the founder of an investment management firm specializing in short selling, recalled shorting the stock of Enron Corporation months before its collapse due to the company's "suspicious" treatment of accounting issues. As it turned out, his scrutiny of the firm was well-placed and his arbitrage trading activity contributed to the market assimilating negative information concerning misleading accounting and financial reporting practices into the company's artificially inflated stock price. *See* Battalio et al., *supra* note 3, at 2; Tom Hamburger et al., *Auditor Warned Enron Against Putting 'Misleading' Information in News Release*, WALL ST. J. (Jan. 23, 2002, 11:39 PM), http://online.wsj.com/article/0,,SB1011808019460543640,00.html.

appreciates the positive effects that speculative trading has on the price discovery process.[65]

A short selling ban, however, hinders efficient price discovery and exposes the market to overvaluation.[66] This measure precludes the influence of short sellers who figure prominently in the speed and accuracy of price discovery by means of informed trading that is imbued with speculative-independent considerations.[67] By eliminating the possibility for investors to place authentic downward pressure on an overpriced stock on the basis of verifiable information, the short selling ban paralyzes the market's capacity to absorb new information and re-price overvalued securities to an equilibrium level.[68] In these circumstances, overvaluation is virtually unavoidable: "Pessimistic investors are forced to sit out of the market when short sales are not available, and thus some negative information is not reflected in price, enabling enthusiastic buyers to bid prices above the level that average investors perceive as fair."[69]

The second advantage of short selling that is frustrated by a trading ban—capital allocation—is intimately related to price discovery. This point centers on the fact that stock prices generally "serve as signals for resource allocation."[70] Because a short selling ban can lead to overvalued securities, as detailed above, the stock prices during these intervals dispatch a "distorted signal" to the market and, as a result, cause "real resources [to] flow to the overpriced stock or industry" when actual market conditions might favor an alternate allocation of capital.[71] What is more, this sub-optimal allocation of resources is capable of producing lasting effects: "[W]hile stocks are liquid financial instruments, the investment in the mispriced firm or industry may not be so liquid, leading to long-term disruptions in the real economy long after the stock price is corrected."[72] It follows that short sellers, to the extent that they "ferret out" overvalued securities and depress stock prices to an

65. Concept Release on Equity Market Structure, Exchange Act Release No. 61,358, 9 SEC Docket 2115, at 53 (Jan. 14, 2010), *available at* http://www.sec.gov/rules/concept/2010/34-61358.pdf.

66. *See, e.g.*, Eric C. Chang et al., *Short-Sales Constraints and Price Discovery: Evidence from the Hong Kong Market*, 62 J. FIN. 2097 (2007); Boehmer & Wu, *supra* note 63.

67. *See* Chang et al., *supra* note 66.

68. *Id.*

69. *Id.*

70. Green, Li & Schurhoff, *supra* note 59, at 2.

71. Battalio et al., *supra* note 3, at 2.

72. *Id.*

equilibrium level in accord with fundamental value, play a key role in facilitating greater efficiency in resource allocation.[73]

Third, the short selling ban strips investors of a prominent tool to hedge risk. The short sale is most often used in conjunction with a long position in a related security.[74] The effect of this dual strategy is to offset exposure in the long position since the short position on the stock acts as a form of downside protection against possible future price decreases.[75] Should the share price rise, the investor enjoys the capital appreciation on the long position and simply bears the cost of the downside "insurance" provided by the short position.[76] Conversely, if the underlying share price falls, the investor is protected to a degree since the loss suffered on the long position on the security will be offset by the gains on the short position on the instrument.[77] Admittedly, most bans contain exemptions for bona fide hedging activities, but investors have nevertheless expressed concern that these restrictions will damage their ability to hedge risk fully and effectively.[78] Accordingly, to the extent that a ban restricts the use of short selling in this legitimate manner, market participants are deprived of a critical risk management strategy and can face difficulty in obtaining the appropriate risk exposure.[79]

Finally, the imposition of regulatory constraints on short selling has a detrimental effect on market liquidity. Liquidity refers to the ease with which a particular security can be transacted and "plays a central role in the functioning of financial markets."[80] A significant body of empirical

---

73. *Id.* at 3.

74. Contrary to popular opinion, the "overwhelming majority of short selling activity today is market neutral" and devoid of a speculative purpose. Stigmark, *supra* note 24, at 33.

75. Brigitte Yuille, *Short Selling: Why Short*, INVESTOPEDIA, http://www.investopedia.com/university/shortselling/shortselling1a.asp (last visited Sept. 26, 2013).

76. *Id.*

77. Short Hedge, THEOPTIONSGUIDE, http://www.theoptionsguide.com/short-hedge.aspx (last visited Sept. 26, 2013). In certain circumstances depending on the nature and relationship of the long and short positions, gains on the short position may be so large that they not only offset losses on a long position but actually generate a profit: "During volatile market periods, this protection busts and a sharp fall in the underlying share price generates a profit that stems from the fact that the gain on the short position on the stock is greater than the loss suffered on the bond." FILIPPO STEFFANI, INVESTMENT STRATEGIES OF HEDGE FUNDS 117 (2006).

78. *See* Joseph Cotterill, *Europe Short-Selling Bans Have Limited Impact*, FIN. TIMES (Aug. 12, 2011, 9:26 AM), http://ftalphaville.ft.com/2011/08/12/651726/europe-short-selling-bans-have-limited-impact/.

79. *Id.*

80. Timothy F. Geithner, President and CEO, Fed. Reserve Bank of N.Y., Keynote Address at the Eighth Annual Risk Convention and Exhibition: Liquidity and Financial

work identifies a positive correlation between uninhibited short selling and market liquidity.[81] Woolridge and Dickinson (1994), for instance, point out that short sellers add liquidity to the stock markets by shorting securities and adding to the trading volume in optimistic markets.[82] Charoenrook and Daouk (2005) similarly found that liquidity, as measured by share turnover, is greater in markets where short selling is freely available since a greater inventory of stock is available for purchase when investors who wish to sell stocks they do not own are not foreclosed from participating in the market.[83] In like manner, Beber and Pagano (2011) employed a regression analysis to conclude that short selling bans negatively impact market liquidity as evidenced by quoted bid-ask spreads that, during the imposition of the short selling bans under review, were exceptionally high.[84] These findings and others demonstrate that restrictions on short selling reduce the volume of trading activity of the affected stocks and impair the mobility of capital. The short selling ban therefore erects regulatory barriers to economically-motivated

Markets (Feb. 28, 2007) (transcript available at http://www.newyorkfed.org/newsevents/speeches/2007/gei070228.html).

81. *See supra* notes 64-66 and accompanying text.

82. Thomas J. Boulton & Marcus V. Braga-Alves, *Naked Short Selling and Market Returns* 6 (Apr. 2009), *available at* http://niri.org/Main-Menu-Category/advocate/Regulatory-Positions/Short-Selling/Naked-Short-Selling-Market-Returns-academic-paper.aspx; *see* Miaoxin Chen & Zhenlong Zheng, *The Impact of Short Selling on the Volatility and Liquidity of Stock Markets: Evidence from Hong Kong Market*, http://efinance.org.cn/cn/aboutme/cmx3.pdf; GREG N. GREGORIOU, HANDBOOK OF SHORT SELLING 252 (2012).

83. Hazem Daouk & Anchada Charoenrook, *A Study of Market-Wide Short-Selling Restrictions* 6, 15 (2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687562; *see also* Chen & Zheng, *supra* note 82; Mary Watkins, *Effectiveness of Short-Selling Bans in Doubt*, FIN. TIMES (July 25, 2012), http://on.ft.com/NvcQIW (concluding that the impact of the European short selling bans on market liquidity was "significant" since shares of major financial institutions in France, Spain, Italy, and Belgium lost a quarter of their turnover). Share turnover is generally regarded as a proxy for market liquidity: the greater the share turnover, the more liquid the particular stock. *Share Turnover Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/s/shareturnover.asp (last visited Oct. 5, 2013).

84. Alessandro Beber & Marco Pagano, *Short-Selling Bans Around the World: Evidence from the 2007-2009 Crisis* 5, 13 (2011), http://www.csef.it/WP/wp241.pdf; *see also* Massimo Massa et al., *The Invisible Hand of Short-Selling: Does Short-Selling Discipline Earnings Manipulation?* (2012), http://www.insead.edu/facultyresearch/research/doc.cfm?did=50361. The bid-ask spread is a common measure of asset liquidity, with a lower bid-ask spread generally indicating greater liquidity. *Bid-Ask Spread Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/b/bid-asspread.asp (last visited Oct. 5, 2013).

transactions and causes market participants greater difficulty and expense in executing orders at a desirable price.[85]

In view of the above, it is fair for policymakers and regulators to conclude that considerable harm would befall the financial system if short selling continued uninterrupted during times of market turmoil. The "harm" in this sense refers to the excessive downward pressure exerted on stock prices in the absence of a fundamental underlying basis, the sharp increase in market volatility, and the erosion of confidence in financial institutions with potential systemic damage to the broader economy.[86] It is equally apparent, however, that short selling constraints have "unintended but important negative consequences" on efficient price discovery, capital allocation, risk management, and market

---

85. Champions of the efficient market hypothesis draw on these benefits in rebuking the imposition of trading constraints, even during times of market turmoil. They assert the unobjectionable position that there is nothing inherently improper with betting that the stock of an unsound company will decline. However, they then reach the untenable conclusion that since short selling is inherently beneficial to market efficiency, it is invariably beneficial to market efficiency. *See* Hamilton Nolan, *Banning Short Selling is Dumb*, GAWKER (Aug. 11, 2001), http://gawker.com/5829942/banning-short-selling-is-dumb; Paul R. La Monica, *Short Selling Won't Stop Bears*, CNN MONEY (July 24, 2012, 12:37 PM), http://buzz.money.cnn.com/2012/07/24/short-selling-ban/. Under this viewpoint, these emergency measures constitute an unjustified interference with the free market economy and amount to nothing more than "a public relations move." *Id.* Displaying obstinate faith in the self-regulating nature of the free market, these detractors proclaim that protection against the adverse affect of speculative short selling is superfluous: "If short sellers are wrong, the market will punish them itself." *Id.* While this argument would carry the day under normal market conditions—indeed, when a firm targeted by short sellers is fundamentally sound and other shrewd investors believe this to be so, optimistic traders will take an opposing position to the short-sellers, place countervailing pressure on the stock price, and "mak[e] the shorting strategy a risky one"—the assumption that the market will invariably regulate itself in this manner fails to account for the stark contrast in market efficiency during normal market conditions and periods of market stress. Battalio et al., *supra* note 3, at 3. Free markets are not unfailingly rational. In instances of bitter market turmoil, the behavioralist line of thinking suggests that "the market is not being driven by fundamentals." Atif Latif, *Short Selling Ban: What the Experts Say*, GUARDIAN (Aug. 12, 2011, 8:19 AM), http://www.guardian.co.uk/business/2011/aug/12/short-selling-ban-experts; *see also* Justin Fox, *Is the Market Rational? No, Say the Experts. But Neither Are You—So Don't Go Thinking You Can Outsmart It*, CNN MONEY (Dec. 9, 2002), http://money.cnn.com/magazines/fortune/fortune_archive/2002/12/09/333473/index.htm. Thus, while a properly functioning market may be capable of detecting and "punishing" imprudent bets, it may not be able to effectively police itself when rife with panic and subject to irrational swings as public sentiment wavers and economic actors stray from reasoned decision making. Jon E. Hilsenrath, *As Two Economists Debate Markets, The Tide Shifts*, WALL ST. J. (Oct. 18, 2004), http://online.wsj.com/article/0,,SB109804865418747444,00.html.

86. *See* Beber & Pagano, *supra* note 84, at 13.

liquidity.[87] These deleterious effects counsel that a short selling ban might actually be counterproductive to the goal of financial stability if the professed benefits of the measure do not accrue to the markets. In this light, it is critical that regulatory officials craft a trading ban that accounts not only for short selling, but for any transaction or practice that allows investors to replicate the economic position of short selling and undermine the ban by driving asset values to artificially low levels. Derivatives constitute such an activity.

III. THE REGULATORY IMPERATIVE FOR HEIGHTENED DERIVATIVES OVERSIGHT IN THE UNITED STATES

Investors unable to obtain the appropriate level of risk or to speculate over the life of a short selling ban can respond in several ways. The first option is to "simply abandon a position altogether and allocate their investment capital elsewhere."[88] This would further dampen trading volumes of the affected stocks and, in turn, would prompt "wide price swings" capable of "making a volatile market worse."[89] In the alternative, investors may restructure their investment strategy to substitute short selling with auxiliary trading strategies that allow them to hedge and take bearish positions on the affected securities in a similar manner.[90] In this regard, the derivative is a well-qualified surrogate for short selling.

Derivatives are "financial contracts whose prices are determined by, or 'derived' from, the value of some underlying asset, rate, index, or event."[91] As it pertains to the short selling ban, the most important types

87. Marco Pagano & Alessandro Beber, *Short-Selling Bans in the Crisis: A Misguided Policy,* VOX (Feb. 6, 2010), http://www.voxeu.org/article/short-selling-bans-crisis-misguided-policy.

88. Eric Parnell, *Ban on Short Selling a Very Bad Sign for Global Stocks*, SEEKING ALPHA (Aug. 12, 2011, 9:38 AM), http://seekingalpha.com/article/286993-ban-on-short-selling-a-very-bad-sign-for-global-stocks.

89. Karmel, *supra* note 11, at 876; *see* Parnell, *supra* note 88.

90. *See* Steven Russolillo, *Short-Selling Ban 'Reeks of Desperation,'* WALL ST. J. (July 23, 2012, 1:25 PM), http://blogs.wsj.com/marketbeat/2012/07/23/short-selling-ban-reeks-of-desperation/; Gary Wright, *Short Selling Ban Will Hit Derivatives*, B.I.S.S. RESEARCH LTD (Oct. 8, 2008), http://www.bissresearch.com/blog/short-selling-ban-will-hit-derivatives/60.

91. FINANCIAL CRISIS INQUIRY REPORT, *supra* note 37, at 45-46. In contrast to the equities markets, which function primarily as an avenue for investment, derivatives are principally used by financial market participants to hedge or transfer risk among counterparties. René M. Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERSP. 73 (2010), *available at* http://fisher.osu.edu/fin/faculty/stulz/publishedpapers/jep%2024%201.pdf. Like short selling, derivatives generally enable an investor to achieve a position that neutralizes the negative performance of other securities: "Losses

of derivative contracts are futures, options, and credit default swaps, each of which raise concerns that are virtually identical to those presented by short selling.[92]

A futures contract represents the first alternative for financial market participants to benefit financially from a price decline in an underlying financial instrument.[93] These agreements are publicly traded and involve a legally binding obligation to buy or sell an agreed amount of a particular asset at a specific future date for a specific price.[94] When research suggests that a decline in value of a particular instrument is probable, an investor is able to profit on that anticipated price reduction, "achieving a similar outcome to short-selling,"[95] by going short on a stock future—that is, by selling a futures contract.[96] That investor might, for instance, enter a futures contract to sell 100 shares of Facebook, Inc. at $38 per share at a future date for a total cost of $3800.[97] While the buyer expects that Facebook shares will increase in value and thus be available for purchase under the futures contract at a bargain, the seller standing on the opposite side of the transaction is betting that by the expiry of the contract, the price of the stock will be lower than $38.[98] If the seller is correct and the value of Facebook stock decreases to $35 per share, the seller can buy the securities on the market at the prevailing market price for a total of $3500 and then exercise his right to sell the shares at the agreed price for a total earnings of $3800, resulting in a $300 profit to the seller for correctly guessing that the stock would decline in value prior to the expiration of the contract.[99] Even while a

---

suffered because of price movements [affecting one security] can be recouped through gains on the derivatives contract." FINANCIAL CRISIS INQUIRY REPORT, *supra* note 37, at 46.

92. *See supra* notes 80-91.

93. *See* JOHN DOWNES & JORDAN E. GOODMAN, BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 230 (5th ed. 1998).

94. *Id.*

95. Jacob Bunge, *OneChicago Offers Derivatives to Counter Europe Short-Selling Ban*, MARKETWATCH (Aug. 18, 2011, 2:27 PM), http://www.marketwatch.com/story/onechicago-offers-derivatives-to-counter-short-ban-2011-08-18.

96. *Id.*

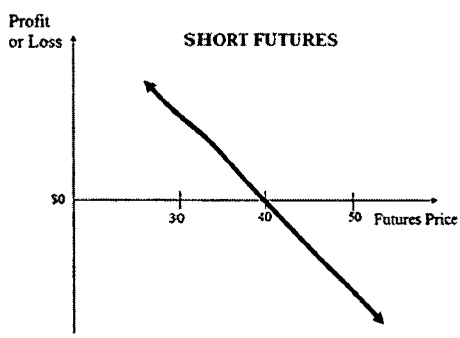
97. This example presumes that a futures contract is available with respect to this company.

98. DOWNES & GOODMAN, *supra* note 93, at 230.

99. *See* Dave Roos, *How Stock Futures Work*, HOWSTUFFWORKS (Aug. 20, 2008), http://money.howstuffworks.com/personal-finance/financial-planning/stock-future1.htm. The following graph demonstrates that the expectations and payoffs of a short-seller and a trader going short on a stock future are identical. In each case, the investor profits from poor future performance in the underlying security and is exposed to uncapped losses in the event the price rises:

short selling ban is in place, therefore, market participants are still capable of establishing a short position to derive profits from a future price reduction.[100]

Purchasing a put option likewise places the trader in a similar economic position to that of the short seller. Put options confer upon the purchaser the right—not the obligation—"to sell a specified number of shares" of an underlying instrument in the future at a predetermined strike price.[101] For example, a purchaser of a put option with a $50 strike price has the *right* to sell the stock for $50 at any time over the life of the contract. If the price of the particular stock falls to $40, the put option increases in value, and the purchaser can profit by exercising its right and selling the stock at a price $10 higher than the current market rate.[102] Consequently, the put option provides investors another alternative for profit on price declines over the course of a short selling ban.[103]



Short Futures Position, THEOPTIONSGUIDE, http://www.theoptionsguide.com/short-futures.aspx (last visited Sept. 26, 2013).

100. *Id.*

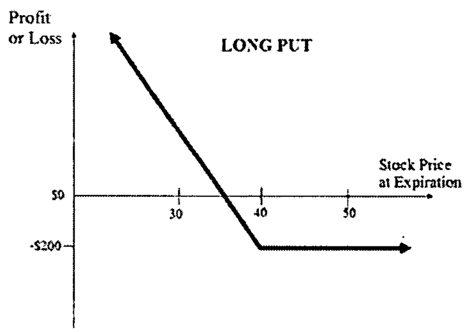
101. DOWNES & GOODMAN, *supra* note 93, at 417.

102. *Put Option*, THEOPTIONSGUIDE, http://www.theoptionsguide.com/put-option.aspx (last visited Sept. 26, 2013). Interestingly, the put option also presents the opportunity for abusive market manipulation, in which traders enter into a put option and simultaneously sell the underlying security short in hopes of driving down the price of the security and profiting on the decline both on the short position and on the put option. *See id.*

103. The chart below demonstrates the overlapping payoffs offered by a short sale and a put option in the event that a stock declines in value. Note, however, that the purchaser of a put option is, in the aggregate, in an economically favorable position as compared to the short seller since the former does not have the obligation to make delivery of the underlying asset and thus can simply forgo exercise of the right if it is not economically feasible. As a practical matter, the purchaser's maximum loss is capped at the initial premium required to obtain the option right:

Credit default swaps represent the final category of substitutes for short selling. A credit default swap is an agreement between two parties in which, like an insurance policy against fire or theft, the "protection buyer" pays fixed premiums at predetermined intervals over the life of the swap.[104] In exchange, the "protection seller" accepts the credit risk of the underlying debt and agrees to make a payment to the buyer contingent on a credit event, such as entry into default.[105] While this tool was intended to enhance market efficiency by enabling "credit risk [to] reside with the investors who are best equipped to bear it," the credit default swap has emerged as a particularly alluring speculative alternative to short selling since this transaction subjects the buyer to minimal risk of loss, capped at the value of the periodic premium

---



Long Put, THEOPTIONSGUIDE, http://www.theoptionsguide.com/put-option-futures.aspx (last visited Sept. 26, 2013).

104. While the credit default swap is frequently compared to insurance, it is critical to understand that this comparison is invoked principally as a theoretical framework to demystify the complex and arcane nature of the transaction, with the seller theoretically "insuring [the purchaser] against a default in the underlying asset." FINANCIAL CRISIS INQUIRY REPORT, *supra* note 37, at 50. However, credit default swaps are far more precarious than insurance contracts in several important respects. First, they are over-the-counter financial derivative products that have historically been subject to very little regulatory oversight. Second, insurance regulations require insurers, when they issue a policy, to set aside reserves to safeguard against potential future losses. No such requirement exists with respect to credit default swaps:

> In the housing boom, CDS were sold by firms that failed to put up any reserves or initial collateral or to hedge their exposure. In the run-up to the crisis, AIG, the largest U.S. insurance company, would accumulate a one-half trillion dollar position in credit risk through the OTC market without being required to post one dollar's worth of initial collateral or making any other provision for loss.

Id.

105. *Id. See also* Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME (Mar. 17, 2008), http://www.time.com/time/business/article/0,8599,1723152,00.html.

payments, and offers enormous profit potential upon default and payment of the face value of the obligation.[106]

Granted, the credit default swap typically relates to a bond or other underlying debt obligation rather than a security and thus is not a perfect substitute for short selling. However, this swap may be used in conjunction with alternate derivative products to propel artificial price movements and engineer short profits in much the same way as short selling. In the volatile markets of 2008, for example, there was a concern that credit default swaps were being used to give the impression that an institution was facing financial difficulty.[107] This negative signal, in turn, would "drive down" the entity's stock price, allowing the manipulators to profit on short positions that had been previously established in futures or options.[108] "Financial institutions could be especially vulnerable to such actions," because they rely heavily on the trust and confidence of their counterparty and "are susceptible to runs."[109]

In view of these alternative means to establish short positions, it is clear that the concerns justifying the ban on short selling are equally apparent with respect to derivatives.[110] Not only is there a concern that investors may establish short positions that are widely thought to induce disorderly markets, but derivatives also present the same risk that investors may speculatively target the stock of a financial institution and artificially depress stock prices.[111]

A ban on short selling is not precatory. This directive, rather, is clear and definite and leaves no doubt of its intention to broadly preclude financial market participants from establishing harmful short positions. However, since these key derivative contracts allow investors to hedge and speculate through alternative and unrestricted means, it is more than conceivable that a well-informed trader would bypass the ban by using derivatives to establish the very same economic positions that the emergency measure sought to forestall.[112] The result: this mandatory decree is effectively relegated to mere precatory words. The clear implication is that if a market participant is able to freely circumvent the

106. Stulz, *supra* note 91, at 75; *see* William C. Dudley & R. Glenn Hubbard, *How Capital Markets Enhance Economic Performance and Facilitate Job Creation*, GOLDMAN SACHS GLOBAL MARKETS INST. 10 (Nov. 2004), http://www0.gsb.columbia.edu/faculty/ghubbard/Articles%20for%20Web%20Site/How%20Capital%20Markets%20Enhance%20Economic%20Performance%20and%20Facilit.pdf.

107. Stulz, *supra* note 91.

108. *Id.* at 84; *cf. supra* note 78.

109. Stulz, *supra* note 91, at 84.

110. *See supra* notes 80-91.

111. *See supra* note 14 and accompanying text.

112. Stulz, *supra* note 91.

short selling ban through this "end run" around its restrictions, the utility of the measure in restoring investor confidence and financial stability is seriously undermined.[113]

It follows that the short selling bans in the United States, to the extent that they are confined exclusively to short selling despite other avenues for going short, are of questionable utility in preventing investors from speculating on price declines and establishing positions deemed detrimental to economic stability.[114] Such an objective cannot be meaningfully achieved when investors are able to evade its restrictions using a simple derivative product. The purposes served by this emergency measure therefore mandate that these trading bans be applied to all avenues for establishing economically identical short positions, irrespective of the manner in which these positions are undertaken.

Short selling bans in the EU boast more promising features than the narrow measures adopted in the United States, particularly with respect to derivatives.[115] Notably, the European Parliament and Council of the European Union have acknowledged the importance of a regulatory regime centered on economic substance to account for all short positions, however formulated, that threaten the enduring stability of the financial system.[116] According to a recent regulation, "Buying credit default swaps without having a long position in the underlying sovereign debt, or any assets, portfolio of assets, financial obligations, or financial contracts . . . can be, *economically speaking*, equivalent to taking a short position on the underlying debt instrument." [117] Therefore, these institutions wisely conclude, it is critical that financial derivatives be restricted in conjunction with limits on short selling.[118]

The EU treatment of derivatives accentuates the failure in the United States to account for trading activity that prudent regulation would otherwise encompass.[119] A short selling ban that is "so easily evaded" through derivatives cannot effectively foster or maintain stability in the

113. *See* Karmel, *supra* note 11, at 879. Even the SEC has expressed uncertainty concerning the value of short selling regulation given the accessibility of derivatives. *See id.* (recognizing, in the context of deliberations concerning reinstitution of the uptick rule, that "the use of derivative products . . . may undermine the goals for adopting" short selling regulation).

114. *See id.* at 875.

115. *Id.* at 861, 880-83.

116. Council Regulation 236/2012, 2012 O.J. (L86) [hereinafter EU Short Selling Regulation], *available at* http:// http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:en:PDF.

117. *Id.* pmbl. para. 14 (emphasis added).

118. *Id.* pmbl. para. 10.

119. *See* Karmel, *supra* note 11, at 880-83.

financial markets.[120] When market conditions arise that create volatility and damage investor confidence, the SEC should pursue more coordinated efforts with the CFTC to develop a comprehensive regulatory framework that addresses all harmful short positions, regardless of whether they are established through short selling or derivatives.[121] This collaborative approach would more effectively impede the ability of pessimistic traders to exert artificial downward pressure on securities prices, heighten uncertainty in the underlying institution, and aggravate volatility in the financial markets.[122]

To be sure, broadening the scope of short selling regulation in this manner would remove yet another avenue for investors to adequately hedge their exposure and may negatively impact price discovery and liquidity.[123] However, if a short selling ban is viewed as necessary to alleviate market volatility, then there is no effective way to impose this restriction and calm the financial markets without simultaneously regulating equivalent short positions undertaken through derivatives transactions. As discussed above, trading in derivatives can reasonably be construed as simply short selling under a different name, posing an equally appreciable threat to the ban's objective. Consequently, although liquidity and other market functions might be impacted, the versatility of derivatives requires that these short positions be regulated to ensure that the ban on short selling is not counterproductive and that the markets are

---

120. *Id.* at 875.

121. U.S. COMMODITY FUTURES TRADING COMM'N & U.S. SEC. & EXCH. COMM'N, JOINT REPORT ON INTERNATIONAL SWAP REGULATION (2012), *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf. Joint consultation and coordination between the SEC and CFTC is not an unworkable solution, but it is in fact becoming increasingly common. Section 719(c) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, for instance, requires the agencies to conduct a combined study and issue a report to Congress detailing the regulation of swaps in the United States, Asia, and Europe. The SEC and CFTC also joined forces to detect that

> [a]ll existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make recommendations for changes to statutes and regulations that would eliminate the differences.

U.S. COMMODITY FUTURES TRADING COMM'N & U.S. SEC. & EXCH. COMM'N, A JOINT REPORT OF THE SEC AND CFTC ON HARMONIZATION OF REGULATION 1 (2009), *available at* http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/opacftc-secfinal jointreport101.pdf.

122. *Id.*

123. *Id.*

not susceptible to short positions capable of driving stock prices below fundamental value.

IV. SALVAGING THE EUROPEAN UNION'S UNSATISFACTORY ATTEMPT AT REGULATORY UNIFORMITY

A heterogeneous collection of short selling regulation has blossomed across Europe in recent years.[124] As introduced above, securities regulators throughout Europe have brandished the short selling ban in an effort to restore stability to an embattled financial system struggling through a severe crisis of confidence, most notably in Greece, Spain, Ireland, and Portugal.[125]

Despite the common goal, there have been radical regulatory departures in terms of the scope, strength, and duration of these prohibitions.[126] On August 11, 2011, the European Securities and Markets Authority (ESMA) announced that regulatory authorities in four countries—Italy, Spain, France, and Belgium—had responded to extreme volatility in the financial system with short selling restrictions in their respective markets.[127] Spain's Comisíon Nacional del Mercado de Valores (CNMV) and Italy's Commissione Nazionale per le Societá e la Borsa (Consob) each reinstated, for fifteen days, earlier measures that prevented traders from establishing short positions in securities of financial institutions.[128] In the weeks subsequent to implementation, both institutions elected to extend the restrictions until at least September

124. *See Europe's Latest Bailout: Greece, Ireland, Portugal and Now Spanish Banks*, WALL. ST. J. (June 12, 2012), http://online.wsj.com/article/SB10001424052702303901504577458051550661994.html.

125. *Id.*

126. Beber & Pagano, *supra* note 84.

127. *See* Public Statement, European Sec. & Markets Auth., ESMA Promotes Harmonized Regulatory Action on Short-Selling in the EU (Aug. 11, 2011), http://www.cmvm.pt/CMVM/Cooperacao%20Internacional/Docs_ESMA_Cesr/Documents/ESMA-%20Public%20statement%20on%20short-selling %2011%2008%202011.pdf [hereinafter ESMA Public Statement]; *4 European Countries Ban Short-Selling*, CBS NEWS (Aug. 11, 2011, 9:24 PM), http://www.cbsnews.com/2100-202_162-20091500.html; Huw Jones, *Four EU States Extend Short-Selling Ban*, REUTERS (Aug. 25, 2011, 12:52 PM), http://www.reuters.com/article/2011/08/25/businesspro-us-shortselling-idUSTRE77O5M120110825.

128. Louise Story & Steven Castle, *Four European Nations to Curtail Short-Selling*, N.Y. TIMES (Aug. 11, 2011), http://www.nytimes.com/2011/08/12/business/global/europe-considers-ban-on-short-selling.html.

30.[129] Later, these measures were again renewed and ultimately remained in place until February 2012.[130]

The French securities regulator, the Autorité des Marchés Financiers (AMF), introduced a short selling ban on a schedule that, at first, closely mirrored Spain and Italy, but that only outlawed short positions in eleven leading financial institutions.[131] Shortly thereafter, and after it revised the scope of the measure to allow investors to maintain preexisting short positions, the AMF announced that the ban would remain in place indefinitely until further notice.[132]

In Belgium, the Financial Services and Markets Authority (FSMA) expanded its prevailing ban on naked short selling to restrict the short selling of financial securities generally.[133] Like in France, the FSMA indicated that this short selling ban would continue indefinitely until market conditions permitted the measure to be lifted.[134]

Financial regulatory bodies in other European countries also considered whether to impose or extend a short selling ban.[135] The Hellenic Capital Market Commission in Greece indicated that it was subjecting its preexisting short sale restrictions, originally set to expire on October 7, 2011 to review for possible extension.[136] Meanwhile, Germany declined to broaden its existing short selling measures, and the United Kingdom, the Netherlands, and Austria each dismissed this movement, refusing to take part in the regulatory wave.[137]

As the foregoing demonstrates, these measures exemplify an unmistakable lack of consistency. Not only have the bans been instituted and withdrawn sporadically, but they have also applied to differing

---

129. *See* Jones, *supra* note 127.

130. *See* Tracy Rucinski & Stephen Jewkes, *UPDATE 3 – Spain, Italy Reinstate Short-Selling Ban*, REUTERS (July 23, 2012 1:02 PM), http://www.reuters.com/article/2012/07/23/italy-consob-short-selling-idUSL6E8INA7O20120723; Nandini Sukumar, *Italy Has No Plans to Extend Short-Sale Ban, Regulator Says*, BLOOMBERG NEWS (Feb. 23, 2012, 11:05 AM), http://www.bloomberg.com/news/2012-02-23/italy-has-no-plans-to-extend-short-sale-ban-regulator-says.html; Christopher Bjork, *Spain's CNMV Lifts Financials Short-Selling Ban*, MARKETWATCH (Feb. 15, 2012, 1:13 PM), http://www.marketwatch.com/story/spains-cnmv-lifts-financials-short-selling-ban-2012-02-15.

131. Rucinski & Jewkes, *supra* note 130.

132. *Id.*

133. *See 4 European Countries Ban Short-Selling*, *supra* note 127; Story & Castle, *supra* note 128.

134. Jones, *supra* note 127.

135. *Id.*

136. *Id.*

137. Story & Castle, *supra* note 128.

segments of listed securities and have contained disharmonized degrees of rigor.[138]

While the fragmented approach sweeping Europe is readily apparent from the summer of 2011, subsequent modifications of these short selling bans further underscore the spectacular degree of regulatory obfuscation. In July 2012, both Italy and Spain reactivated their short selling bans when confronted with "extraordinary market conditions . . . characterized by a significant increase in volatility and a sharp fall in prices."[139] This move was unsurprising given the regulators' ceaseless resort to the short selling ban to dispel volatility. In Italy, the preventive measure was confined to banking and insurance stocks and was intended to endure for only a week.[140] In Spain, by contrast, the CNMV banned the short selling on all equity securities, including the use of derivatives to establish short positions, for a three-month period until October 23, at which point the measure would either be lifted or renewed.[141] Predictably, in the latest move of this string of regulatory responses, Spain acted on October 19, 2012 to extend its short selling ban of all stocks for another three months until at least early 2013.[142]

This splintered approach to short selling regulation risks increasing market uncertainty and impairing the impact of the bans.[143] By forcing market participants to weather a "multiplicity of regimes," a system marked by incompatible regulation casts a mantle of regulatory uncertainty over the financial markets and obstructs the movement toward stability and recovery.[144] In fact, the presence of piecemeal regulation undermines the very purpose of the short selling ban in the first place, which was to relieve the market of uncertainty and strengthen investor confidence in the financial markets. This uniform problem requires unified efforts. Elaborating on the role for securities regulators

---

138. Pagano & Beber, *supra* note 87.

139. Mary Watkins, *Spain and Italy Resume Short-Selling Bans*, FIN. TIMES (July 23, 2012, 4:43 PM), http://www.ft.com/intl/cms/s/0/e4f8069c-d4d1-11e1-bb88-00144feabdc0.html.

140. *Id.*

141. *Id. See* Russolillo, *supra* note 90.

142. *See* David Román, *Spain to Extend Short-Selling Ban*, WALL ST. J. (Nov. 1, 2012, 4:30 AM), http://online.wsj.com/article/SB10001424052970204712904578092133007493810.html.

143. *See* Jones, *supra* note 127.

144. FIN. SERV. AUTH., SHORT SELLING 23 (2009) [hereinafter FSA Discussion Paper], *available at* http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf. The Federal Reserve Bank of Atlanta has stated that "[t]he importance of this policy uncertainty in the midst of a crisis perhaps is too little appreciated." Gerald P. Dwyer, *Short Selling: Costs and Benefits*, CTR. FOR FIN. INNOVATION & STABILITY, FED. RES. BANK. ATLANTA (Nov. 2009), http://www.frbatlanta.org/cenfis/pubscf/vn_short_selling.cfm.

in confronting systemic risk, the International Organization of Securities Commissions (IOSCO) has corroborated this point by noting that "[p]romoting financial stability is a shared responsibility amongst the regulatory community."[145]

Against this backdrop, the European Parliament and Council of the European Union adopted a regulation, Regulation (EU) No. 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps (the Regulation), which puts forward a detailed blueprint to coalesce Member State regulation of the European equity and sovereign debt markets. The stated aim of this Regulation, which took direct effect on November 1, 2012,[146] is "[t]o end the current fragmented situation in which some Member States have taken divergent measures and to restrict the possibility that divergent measures are taken by competent authorities."[147]

As a preliminary note, the decision to pursue a harmonized short selling regime through a regulation, as opposed to a directive, is instructive of the value of concerted short selling regulation.[148] Article

---

145. TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, MITIGATING SYSTEMIC RISK: A ROLE FOR SECURITIES REGULATORS (2011), *available at* http://www.cssf.cl/cssf/docs/IOSCO_RiesgoSistemico.pdf. In relation to short selling, the IOSCO has published a consultation report in which it sets forth a set of four principles "intended to strike a balance between realising as much as possible the potential benefits of short selling (such as correcting overpriced stock, facilitating price discovery, facilitating hedging and other risk management, promoting liquidity through market making) whilst reducing the potential risks associated with short selling." IOSCO CONSULTATION REPORT, *supra* note 34, at 7. These principles include:

> (a) Short selling should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets.
> (b) Short selling should be subject to a reporting regime that provides timely information to the market or to market authorities.
> (c) Short selling should be subject to an effective compliance and enforcement system.
> (d) Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.

Id. at 5.

146. A regulation with "direct effect" is one that is clear, precise, and unconditional, such that that it gives rise to individual rights that agencies and courts of member states are obligated to recognize and effectuate. *See* Case 26/62, NV Algamene Transp.en-Expeditie Ondememing Van Gend en Loos v. Neth. Inland Revenue Admin, 1963 E.C.R. 1 (1963).

147. EU Short Selling Regulation, *supra* note 116, pmbl. para. 5.

148. Consolidated Version of the Treaty on the Functioning of the European Union art. 288, Mar. 30, 2010, 2010 O.J. (C 83) 172 [hereinafter TFEU], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:en:PDF.

288 of the Treaty of the Functioning of the European Union (TFEU) expressly provides that "directive[s] . . . leave to the national authorities the choice of form and methods."[149] Consequently, this form of legislative act would merely "direct" the Member States to conform to a basic regulatory structure and would require independent transposition of the contemplated measure at the state level.[150] As such, it is doubtful that a directive on the matter would have produced coordinated results.[151] Indeed, in these circumstances, national regulators have a very clear motivation to structure the regulatory framework to their best advantage and are unlikely to independently elevate harmonization aspirations over domestic concerns.[152] Invariably, "[w]here national regulators perceive a strong national interest in a regulatory reaction to a problem in the capital markets, they go their own ways."[153] Conversely, Article 288 defines a "regulation" as a binding legislative act with "direct applicability," meaning that it becomes a part of the national legal order upon enactment and entry into force at the EU level and thus does not require separate transposition into domestic law.[154] By withdrawing the amount of flexibility afforded to the states, a regulation bypasses the very fragmentation that it seeks to dispel and, consequently, is a more tailored means to remedy the heart of the issue.[155]

Substantively, the Regulation makes several positive inroads in engineering a comprehensive and effective European regulatory and supervisory framework. This legislation subjects markets to a standard set of rules governing (i) transparency requirements for net short positions and (ii) restrictions on uncovered short selling and credit default swaps. But, in certain key respects, the Regulation is far from the catalyst for coordination that proponents would like it to be. To the contrary, the legislation is engrained with critical flaws capable of repressing the measure's desired harmonization effect.

With regard to the disclosure requirements, the Regulation builds upon a 2004 directive on transparency standards for long positions by establishing uniform reporting obligations for net short positions in listed shares and sovereign debt.[156] Specifically, the Regulation requires that net short positions in shares be reported to the competent national authority or disclosed publicly once certain threshold amounts are

149. *Id.* art. 288.
150. *Id.*
151. *Id.*
152. Karmel, *supra* note 11, at 883.
153. *Id.*
154. TFEU, *supra* note 148, art. 288.
155. *See* Jones, *supra* note 127.
156. *Id.*

triggered.[157] According to the Regulation, a net short position in relation to the issued share capital of a company refers to the "position remaining after deducting" all long positions held in relation to the issued share capital from all short positions held in such capital.[158] A similar disclosure requirement is imposed with regard to net short positions in sovereign debt, with the primary difference being that these positions need not be publicly disclosed.[159]

A net short position in sovereign debt is defined as the position remaining after deducting from any short position in the sovereign debt (a) any long positions in the sovereign debt and (b) any long positions in the debt obligations of a sovereign issuer, the pricing of which is highly correlated to the pricing of the sovereign debt.[160] The Regulation

---

157. The EU Regulation requires that net short positions be reported to the competent regulatory body once they hit a notification threshold of "0,2% of the issued share capital of the company concerned and each 0,1% above that." EU Short Selling Regulation, *supra* note 116, art. 5. The notification requiring disclosure of net short positions to the public is "0,5% of the issued share capital of a company concerned and each 0,1% above that." *Id.* art. 6(2); *see also* Stuart Willey et al., *The EU Short Selling Regulation Comes Into Force*, Insight: Capital Markets (White & Case, London, Eng.), Nov. 2012 [hereinafter W&C Alert], *available at* http://www.whitecase.com/files/Publication/83a9ff70-03f5-46d4-a282-6ee1f2cf7662/Presentation/PublicationAttachment/f2a3c609-c0f9-465a-b5a8-95c38775137e/alert-eu-short-selling-regulation.pdf.

158. EU Short Selling Regulation, *supra* note 116, art. 3(4). Short positions in connection with either issued share capital or issued sovereign debt arise from any the following:

> (a) a short sale of a share issued by a company or of a debt instrument issued by a sovereign issuer; [or]
>
> (b) entering into a transaction which creates or relates to [another] financial instrument . . . [with] the effect [of] . . . confer[ring] a financial advantage . . . in the event of a decrease in the price or value of the share or debt instrument.

Id. art. 3(1). "[L]ong position[s] relating to issued share capital or issued sovereign debt" include those that develop from:

> (a) holding a share issued by a company or a debt instrument issued by a sovereign issuer; [or]
>
> (b) entering into a transaction which creates or relates to [another] financial instrument . . . [with] the effect . . . [of] confer[ring] a financial advantage in the event of an increase in the price or value of the share or debt instrument.

Id. art. 3(2).

159. EU Short Selling Regulation, *supra* note 116, art. 7. The reporting thresholds regarding net short positions in issued sovereign debt are broken down into categories that vary depending on the total amount of issued sovereign debt outstanding. When that amount is between "€0 and €500 billion, the threshold is 0.1%." W&C Alert, *supra* note 157, at A-2. When the total amount is above €500 billion or when the futures market pertaining to sovereign debt has a high trading volume, the threshold is 0.5%. *Id.*

160. EU Short Selling Regulation, *supra* note 116, art. 3(5).

instructs that the relevant time for calculating a net short position is midnight at the end of the trading day on which the position is held and, further, that the notification of such position to the relevant authority or disclosure to the public must be made by 3:30 p.m. on the subsequent trading day detailing (i) the natural or legal person who holds the relevant position, (ii) the size of the position, (iii) the issuer with respect to which such position is maintained, and (iv) the date on which such position was established.[161] The disclosure of information to regulators concerning significant short positions, which is consistent with the IOSCO's second principle on short selling regulation,[162] is generally regarded as an advantageous monitoring scheme because it "shed[s] light" on market participants who drive trading and provides "early warnings of potentially disruptive or abusive use of short sales."[163]

In addition, the Regulation generally suspends uncovered, or naked, positions in sovereign credit default swaps.[164] A position in a credit default swap is deemed to be uncovered when the transaction does not serve to hedge against the following: (a) the risk of default of the issuer when the market participant has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates, or (b) the risk of a decline of the value of the sovereign debt when the market participant holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets, or financial obligations the value of which is correlated to the value of the sovereign debt.[165]

The Regulation imposes a similar ban on uncovered short sales in issued shares and sovereign debt. The Regulation provides that a market participant may enter into a short sale of a share only if (a) the person has borrowed the share or has made alternative provisions resulting in a similar legal effect, (b) the person has entered into an agreement to

---

161. *Id.* art. 9(1).

162. *See* TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, *supra* note 145.

163. FSA Discussion Paper, *supra* note 144, at 13; IOSCO CONSULTATION REPORT, *supra* note 34, at 12. There are also studies demonstrating that "excessive transparency can reduce liquidity because traders are unwilling to reveal their trading strategies." FSA Discussion Paper, *supra* note 144, at 13. However, the standards governing the reporting obligations look to be proportionate with regard to the aim pursued and do not rise to the level at which they would present significant liquidity concerns. *See id.* Indeed, the European Parliament and Council of the European Parliament appear to have been cognizant of this concern. *See* EU Short Selling Regulation, *supra* note 116, pmbl. para. 8 ("Such a requirement should only include private disclosure to regulators as publication of information to the market for such instruments could have a detrimental effect on sovereign debt markets where liquidity is already impaired.").

164. *Id.* pmbl. para. 22.

165. *Id.* art. 4(1).

borrow the share or has another enforceable claim entitling the person to ownership, or (c) the person has made an arrangement with a third party creating a reasonable expectation that the shares will be available for settlement when due.[166] Short sellers of sovereign debt are subject to equivalent restrictions, so that this short position may only be entered into if (a) the person has borrowed the sovereign debt or made similar arrangements, (b) the person has entered into an agreement to borrow the sovereign debt or has an enforceable claim with comparable effect, or (c) the person has made an arrangement with a third party which reasonably ensures that the sovereign debt will be available for settlement when due.[167] As with sovereign credit default swaps, the restriction on uncovered short sales of sovereign debt does not apply if the transaction serves to legitimately hedge a long position in the debt instruments of an issuer.[168]

Curiously, unlike certain other provisions of the Regulation, the restriction on uncovered short sales of shares appears to lack extraterritorial effect. Alternate provisions of the Regulation make clear that the relevant restriction applies to trading activity both inside and outside the EU. For example, Articles 5 and 6 of the Regulation discussed above, which detail the notification and public disclosure obligations of significant net short positions in shares, explicitly extend to net short positions relating to "issued share capital."[169] This term is defined to include both a "share" issued by a company or any other "financial instrument" that creates a short position.[170] The inclusion of "financial instrument" is important because this is the source of the extraterritorial reach. The Regulation defines "financial instrument" expansively to cover transferable securities, which, in turn, includes depositary receipts in respect of company shares and any other securities giving the right to acquire or sell such transferable securities.[171] The effect of this language is to extend the application of these provisions to short positions in instruments, such as American depositary receipts and dual-listed securities, regardless of where these trades are physically executed.

The language of Article 12 relating to uncovered short sales, however, makes no equivalent mention of "financial instruments."

166. *Id.* art. 12(1).
167. *Id.* art. 13(1).
168. W&C Alert, *supra* note 157.
169. EU Short Selling Regulation, *supra* note 116, art. 5-6.
170. *Id.* art. 3(1).
171. *See* Directive 2004/39/EC, of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, Annex I, § C, 2004 O.J. (L 145) 41, 42.

Instead, this section provides only that market participants are generally prohibited from entering into a naked short sale of a "share" unless certain conditions are fulfilled. With the reference to "financial instrument" excluded, this restriction seemingly lacks extraterritorial effect and is therefore only applicable to trading inside the EU. Given that many countries currently have similar restrictions on naked short selling in place, this oversight is not likely to compromise the overall effectiveness of the Regulation; however, it is certainly startling that the EU would elect to rely exclusively on the regulatory authority of a third country to continue to regulate this damaging practice.

The most fundamental deficiency of this Regulation relates to its failure to establish regulatory standards with respect to covered short selling. Article 12 of the Regulation signals that the EU has abolished all restrictions on covered short selling, thereby allowing this practice to occur without limitation despite the fact that several member states have continuously targeted covered short selling in view of its tendency to exacerbate disorderly markets.[172] The competent financial authorities of at least seven countries within the EU—Germany, France, Spain, Italy, Belgium, Greece, and Turkey—have all independently determined that a prohibition on covered short selling in some or all securities was critical to ensuring the fair and orderly operation of the securities markets.[173] Without explanation, however, the Regulation swiftly casts aside all covered short selling restrictions in spite of the belief that "[i]t is the only way to tackle destructive speculation convincingly."[174]

While the Regulation envisions a pan-European short selling regime that allows for the unbridled use of the covered short sale, an exemption route affords competent national authorities some latitude to intervene in "exceptional circumstances."[175] This exception is set forth in Article 20 of the Regulation, which stipulates that national securities regulators are

---

172. Memorandum, European Comm'n, Commission Delegated Regulation on Short Selling and Credit Default Swaps – Frequently Asked Questions (July 5, 2012), http://europa.eu/rapid/press-release_MEMO-12-523_en.htm?locale=en; *see* Watkins, *supra* note 139 and accompanying text.

173. *See* Story & Castle, *supra* note 128; *Germany Calls for European Ban on Short-Selling*, FRANCE 24 (Dec. 8, 2011, 1:10 PM), http://www.france24.com/en/20110812-germany-calls-europe-wide-ban-short-selling-stocks-markets-debt-crisis; *Short Selling Bans Exacerbate Market Crises*, DARECONOMICS (Nov. 12, 2012), http://dareconomics.wordpress.com/2012/11/12/short-selling-bans-exacerbate-market-crises/; *Turkey Limits Shorting; Stocks Bounce*, FIN. TIMES BLOG (Aug. 11, 2011, 4:27 PM), http://blogs.ft.com/beyond-brics/2011/08/11/turkey-stocks-bounce-on-short-selling-ban/#axzz2CuCEMQos.

174. *Germany Calls for European Ban on Short-Selling*, *supra* note 173.

175. EU Short Selling Regulation, *supra* note 116, art. 20.

entitled to prohibit or impose conditions relating to short selling or any other transaction that creates a short position in which:

> (a) there are adverse events or developments which constitute a serious threat to financial stability or to market confidence in the Member State concerned or in one or more other Member States; and
>
> (b) the measure is necessary to address the threat and will not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits.[176]

The Regulation instructs that any measures adopted pursuant to this provision may only remain in place for an initial period of three months, although this period may be renewed for an indefinite number of three-month increments if the circumstances prompting the measure persist.[177]

Importantly, the ESMA assumes responsibility for overseeing any supplementary developments and for ensuring that "a consistent approach is taken by competent authorities regarding measures taken."[178] To assist in this pursuit, the Regulation confers powers on the ESMA "to coordinate measures taken by competent authorities or to take measures itself" to achieve and maintain a harmonized framework.[179]

This "exceptional circumstances" provision is overly expansive and affords competent authorities wide latitude to regulate in a manner that undercuts the harmonization effort. Indeed, the prevailing financial instability stemming from the sovereign debt crisis appears to fall squarely within the Article 20 exception. The Consob in Italy, for instance, previously extended its measures preventing net short positions on financial shares after observing that "*exceptional markets conditions*" still persisted.[180] This Consob resolution continued that "it is *necessary and extremely urgent* to further extend the restrictive measures"[181] to ensure "the orderly conduct of trading and protection of investors."[182]

176. *Id.*
177. *Id.*
178. *Id.* art. 27(1).
179. *Id.* pmbl. para. 3.
180. Consob Resol. No. 17993, COMMISSION NAZIONALE PER LE SOCIETÁ E LA BORSA (Nov. 11, 2011), http://www.consob.it/mainen/documenti/english/resolutions/res17993.htm (emphasis added).
181. Consob Resol. No. 18060, COMMISSION NAZIONALE PER LE SOCIETÁ E LA BORSA (Jan. 11, 2012), http://www.consob.it/mainen/documenti/english/resolutions/res18060.htm (emphasis added).
182. *Id.* (emphasis added).

Similarly, the CNMV banned short selling of all stocks given that "European securities markets are going through a period of *extreme volatility* which might cause their disorderly functioning and affect the normal development of financial activity. In these conditions it is necessary to review the operation of securities markets in order to ensure financial stability."[183] The ESMA, moreover, has advocated for harmonized regulation with respect to covered short selling, citing "*very volatile*" European financial markets.[184] The critical lesson here is that "exceptional circumstances" existed well before the Regulation became effective and are likely to persist well into the foreseeable future. Prior expressions of the competent authorities make clear that adverse developments arising out of the sovereign debt crisis are almost certain to "constitute a serious threat to financial stability or to market confidence in one or more Member States."[185]

The astonishing effect of this Regulation, therefore, is to carve out an exception for preventive regulatory measures that, although ostensibly designed to allow member state divergences in only very limited circumstances, is sufficiently broad to authorize unilateral intervention on day one. And, indeed, that is exactly what occurred. On October 19, 2012, Spain's CNMV announced that pressing market conditions had prompted it to impose, on November 1, 2012, a three-month prohibition on short selling pursuant to Article 20 of the Regulation.[186] The CNMV also indicated, in a statement of sheer optimism, that "[t]he measure may be lifted before the end of the period if circumstances permit."[187] However, market volatility is unlikely to subside in the near term, as the sovereign debt crisis is widely expected to burgeon with increasing intensity well into 2013.[188]

---

183. Comisión Nacional del Mercado de Valores (July 23, 2012), http://www.cnmv.es/loultimo/BAN%20SHORT%20SELLING.pdf (emphasis added); *see* Chiara Albanese, *Spain and Italy Ban Short-Selling*, INVESTMENT EUR. (July 23, 2012), http://www.investmenteurope.net/investment-europe/news/2193559/spain-and-italy-ban-shortselling (quoting another source).

184. ESMA Public Statement, *supra* note 127.

185. EU Short Selling Regulation, *supra* note 116, pmbl. para. 27, art. 11(2).

186. Comisión Nacional del Mercado de Valores (Oct. 19, 2012), http://www.cnmv.es/loultimo/acuerdo%20prorroga%20cortos%20english.pdf.

187. *Id.*

188. *See* Holly Ellyatt, *Greece Needs Another 80 Billion Euros: Goldman Sachs*, CNBC (Nov. 13, 2012, 8:29 AM), http://www.cnbc.com/id/49801433 (expressing doubts of current measures to assist Greece and indicating that a more drastic debt reduction of approximately €80 billion is required); *Europe's Lingering Crisis Augurs Badly for Its Clout*, WALL ST. J. (Nov. 15, 2012, 6:11 PM), http://online.wsj.com/article/SB10001424127887324556304578121030501026460.html?mod=WSJ_article_RecentColumns_BrusselsBeat; Mark Thompson, *Eurozone Risks Rising as Outlook Darkens*, CNN

After exposing the true nature and impact of the "exceptional circumstances" provision, it is clear that the Regulation is properly viewed less as a catalyst for change and coordination and more as an imprimatur to the national competent authorities to continue the status quo.[189] At the very least, the Regulation should have prescribed standards governing covered short selling regulations should they be required, but it fails to do so.[190] Instead, this broad exception defeats the purpose of the Regulation by effectively affording member states a "green light" to unilaterally adopt measures on their own terms as they see fit.[191] As such, there are no effective restrictions in place to prevent the same degree of regulatory disparity from reemerging.[192] Since many regulators have resorted to the short selling ban in the past, there is little reason to doubt that they will perceive the need to do so again in the future.[193] Thus, with respect to covered short selling, the Regulation does not represent a step forward but actually functions to entrench the regulatory fragmentation that prompted the pan-European response in the first instance. The quandary, therefore, is that the "cure" reinforces the ailment, with the result that a resurgence of asymmetric regulatory frameworks will place "greater coordination and consistency between Member States" in jeopardy.[194]

Accordingly, to the extent that it fails to establish adequate standards governing covered short selling and empowers national authorities to respond unilaterally and unconditionally, the Regulation is insufficient to "end the current fragmented situation in which some Member States have taken divergent measures and to restrict the possibility that divergent measures are taken by competent authorities."[195] If harmonization on this front is to be achieved to any degree, the ESMA would be wise to apply its regulatory weight, consistent with its "facilitation and coordination role," to further the purpose of the Regulation in harmonizing the rules

MONEY (Nov. 20, 2012, 10:18 AM), http://money.cnn.com/2012/11/20/investing/eurozone-debt-crisis/index.html.

189. *See* EU Short Selling Regulation, *supra* note 116, para. 2.

190. *See id.* at para. 4.

191. *See Pubblico Ministero v. Ratti*, Case 148/78,1979 E.C.R. 1629, 1 C.M.L.R. 96 (1979) (recognizing that unilateral member state developments cut against the purpose of approximation of laws).

192. *See* W&C Alert, supra note 157.

193. When national authorities are given the flexibility to regulate, it is important to remember that "[w]here national regulators perceive a strong national interest in a regulatory reaction to a problem in the capital markets, they go their own ways." Karmel, *supra* note 11, at 883.

194. EU Short Selling Regulation, *supra* note 116, at paragraph 2.

195. *Id.* at paragraph 5.

for short selling and ensure that the common European short selling framework, still in its infancy, develops uniformly.[196]

V. CONCLUSION

The short selling ban is not a panacea for a nation's deeper financial troubles. Regulators' bid to eliminate the sources of instability that necessitate the short selling ban in the first place calls for fundamental restructuring, not ex post initiatives. Nevertheless, if economic conditions arise that provoke a ban on short selling to eliminate the negative effects of this activity, securities regulators in the United States and European Union can materially enhance the effectiveness of these measures by closing several important regulatory gaps.

As for the short selling regime in the United States, the SEC should work with the CFTC to broaden the ban to reflect the fact that, from an economic perspective, short positions in financial securities may result from transactions other than short selling, particularly derivatives. The continued failure to tailor its response in this manner threatens to undermine the aim of the short selling ban by enabling traders to speculate just as effectively on adverse developments affecting the value of stock and the viability of the underlying institution.

Further, although the EU's recent regulation is a welcome shift towards coordinating divergent short selling regulation, the Regulation in itself is insufficient to engender the desired consistency with regard to covered short selling given the extremely volatile economic climate and the breadth of the "exceptional circumstances" exception. As a result, the ESMA should ensure that unilateral member state restrictions on covered short selling, presuming they continue to emerge, are implemented consistently across Europe.

How diligently the competent authorities pursue these refinements will determine whether short selling regulation will effectively foster and maintain the orderly and efficient functioning of the international financial markets.

196. *See* ESMA, *supra* note 127.