

**ABI remarks on CESR call for evidence  
on regulation of short selling by CESR  
members**

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ABI, on behalf of the Italian banking system, is pleased to have the opportunity to set out its position with regard to short selling, specifically referring to the ban imposed by national Authorities to curb excessive market volatility. This is of particular interest to banks, as short selling is a tool used by financial intermediaries and investors in pursuing their investment policies, as well as an important element in maintaining the balance of the market.

The measures relating to short selling have been adopted at a time of exceptional market situation (in terms of volume and price volatility), characterized by a flow of information from the banks about their exposure to financial institutions in distress. Certainly, this systemic crisis has resulted in actions being promptly taken by the Authorities. Last September, when bans were introduced, volatility was significantly high; therefore, the ban imposed by the Commission was justified. To date, however, the situation is different and there is less price volatility compared to recent months; therefore, those extraordinary circumstances that led to the adoption of restrictive measures are no longer present.

Short selling cannot therefore be considered as the main cause of market volatility. It's generally known that this practice is a key element of financial market efficiency, not only with regard to secondary markets, since it's also an important tool for successful transactions in the primary market.

Last year was characterized by a decline in volumes in the primary market. Although this is largely due to the fact that the overall macroeconomic and market situation had worsened with respect to the first part of the year, as well as to the lack of liquidity available to investors to invest in equities, it is reasonable to assume that the loss of the ability to perform arbitrage and/or hedging operations by investors has also been a negative element for activities on the capital market.

Hedging activities, in fact, in addition to being used on a daily basis for optimal management of investment and market making activities, have always helped to favor the placing of convertible bonds and capital increases for long-term investment on the primary market. The intended parties of these issues are both the so-called outright investors, i.e. those investors who take positions on securities on the basis of opinions concerning the company fundamentals while maintaining a risk exposure to the underlying purchased aggregate asset, and those investors whose demand results from the ability to perform hedging activities with regard to specific risks or simple arbitrage activities.

Therefore, we believe that the restrictions on short selling risk having adverse effects on financial markets, greater than the potential effects that we want to avoid.

For what concerns market trends before and after the introduction of restrictions, there is no evidence that the action taken by the Authorities has effectively curbed medium-term volatility. In particular, looking at the performance of the U.S. market and that of some European countries which adopted different approaches on short selling, it seems clear that the performance of the financial sector's securities is primarily linked to fundamental factors, such as changes in the different countries' macroeconomic environment and financial sector, rather than to the impact of the restrictions<sup>1</sup>.

This could be explained by the fact that the problem pertaining to the extreme volatility that has characterized stock markets in the last quarter of 2008, rather than being ascribable to speculative strategies, is due to the significant disposal of positions by investors, especially institutional investors. Since shares were the only type of securities that remained liquid during the crisis, they were sold, especially by funds, to meet their underwriters' redemption requests.

We should also take into account that the ban on short selling has a greater impact on retail investor operations, obviously in case such operation is allowed by the intermediary, than on institutional investors, the only players who are able to actually influence stock price trends.

While retail investors usually have their securities deposited with the same intermediary with whom they operate on the market (and thus the latter may check the availability/property of securities when the order is made), institutional clients, especially foreign investors, use, for trading purposes, brokers who do not hold their securities in custody. This makes it impossible for brokers to make any kind of check over the type of sale (whether covered or uncovered); therefore, they must rely on their customers' statements, which are also impossible to verify. This, in our opinion, makes any ban ineffective.

As indicated above, while on the one hand there are serious doubts about whether the ban on short selling is effectively able to significantly prevent downward price trends, on the other hand, we believe that this prohibits a practice that is legal and commonly regarded as a key element of financial market efficiency.

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<sup>1</sup> In particular, we note the following:

- In the United States (after the restrictions), the sector index lost 25% against a drop of 11.5% in the S&P; 500;
- In the UK, the FIG index has lost 30% since September (the date of introduction of the bans) against a FTSE index falling by 10%;
- In Germany, although more limited restrictions were imposed, the FIG sector lost approximately 30% against a 21% decline in the DAX;
- In Italy, where severe restrictions were introduced, the FIG sector lost 28%, in line with the performance of the S&P MIB index.

Another problematic issue that has arisen regards the extremely short life of the measures taken, which in certain cases they have been renewed and their provisions substantially modified. We believe this has not allowed intermediaries to implement medium-to-long term organizational procedures and protections, given the uncertainty relating to regulatory choices and the uncertainty relating to whether the bans would continue or eventually be lifted.

Although we are aware of the economic situation and urgency in which the Authorities had to take action, there was a degree of uncertainty with regard to the interpretation of the contents of the measures. Greater simplicity of rules would have helped banks to verify that the restrictions imposed upon customer operativeness are complied with, thus minimizing compliance risk.

It should also be noted that the restrictions on short selling adopted by Member States to curb excessive market volatility were taken on an individual basis, without effective coordination or harmonization of the measures to be taken.

This added an element of diversity in an increasingly integrated European stock market; moreover, on the one hand, it made it even more difficult to perform cross-border transactions on the markets, and, on the other hand, it allowed regulatory arbitrage, making the restrictive measures even more ineffective.

In light of these considerations, we believe that the restrictive measures in terms of short selling adopted by Authorities starting September, although justified by an undoubtedly critical market situation, have limited transactions performed by investors on the primary and secondary markets and significant compliance issues relevant to intermediaries have arisen; moreover, they contributed only marginally to curb share volatility. We therefore believe these measures should not be renewed.

However, we believe that the problem of short sales should be closely examined by the authorities and the market.

As you may be aware, some European Authorities are studying or have already implemented alternative solutions to restrictive measures, of information type, which have the advantage of not limiting operations on the markets, but to act in advance and use moral suasion to enable authorities to effectively monitor market performance.

ABI fully supports CESR's work to assess the impact of measures taken in the member States, in view of the importance of adopting homogeneous regulations at the European level, not only to achieve a truly integrated European capital market but, most of all, to avoid the undesirable

phenomena of regulatory arbitrage, which produce harmful effects for countries with more stringent regulations.

Therefore, we hope that, following the work of CESR and the experience acquired in recent months, we will achieve greater coordination among national Authorities.