

European Commission  
Directorate General  
Internal Market and Services  
B-1049 Brussels  
Belgium

July 9, 2010

By email

Dear Sirs,

**Re: ICMA Response to EC Public Consultation on Short Selling**

We thank you for this opportunity to express our views on this important topic. As a self-regulatory organisation in Europe, we are keen to work with the regulatory authorities. For over 40 years, ICMA has facilitated interaction between market participants for the benefit of an efficient and well-functioning international securities market. ICMA's objectives are the promotion of "best practices" and standards, contributing to education, helping supervisory authorities and furthering links between members.

The subject of short selling is one that has been analysed by regulators for many years, with the overall conclusion being that short selling is a well-established practice that plays an important role in financial markets. As CESR noted in its March 2010 Report, "It contributes to efficient price discovery, increases market liquidity, facilitates hedging and other risk management activities and can possibly help mitigate market bubbles." However, it is worth noting that this view has been informed by numerous academic studies that establish the benefits to the market of short selling and the dangers of regulating in this area. The following are of note:

1. Miller, E. (*Uncertainty and Divergence of Options*, 1977, *Journal of Finance* 32) concludes that short selling restrictions tend to increase the magnitude of overpricing relative to fundamental value.
2. Bai, Y., Chang, E.C., Wang, J. (*Asset Prices under Short-Sale Constraints*, University of Hong Kong and MIT Working Paper 2006) argue that with the imposition of short selling restrictions, stock prices may be lower because investors will demand a higher risk premium.
3. Bris, A., Goetzmann, W.N., Zhu, N. (*Efficiency and the Bear: Short Sales and Markets Around the World*, 2007, *Journal of Finance* Vol 62, No 3) conclude that in countries where short selling is allowed and practiced, measures of market efficiency indicate marginally but significantly higher efficiency. They also found that short sales do not affect the frequency of extreme negative returns. Moreover, when they analysed changes in short sales

regulation in five countries (Hong Kong, Malaysia, Thailand, Sweden and Norway) they found that removing restrictions on short sales led to gains in efficiency and the negative skewness of market returns increases marginally. Apart from this study, there is no other research on the hypothesis that short selling may amplify price swings.

4. Bris, A. (*Short Selling Activity in Financial Stocks and the SEC July 15<sup>th</sup> Emergency Order*, 2008, [www.imd.ch/news/upload/Report.pdf](http://www.imd.ch/news/upload/Report.pdf)) argues that the SEC 15 July 2008 Emergency Order was associated with a decline in the liquidity of the stocks that were the subject of the Order. Moreover, he finds that the affected stocks suffered a significant decline in market efficiency and in market quality (liquidity and volatility) following the Emergency Order.
5. Clifton, M., and Snape, M. (*The Effect of Short-selling Restrictions on Liquidity: Evidence from the London Stock Exchange*, 2008, report commissioned by the London Stock Exchange) found that after the temporary ban on short selling imposed by the UK FSA in September 2008, stocks on the restricted list had lower liquidity compared to the control stocks.
6. Boehmer, E., Jones, C.M., Zhang, X. (*Shackling Short Sellers: The 2008 Shorting Ban*, 2008, preliminary draft, <http://www.tinbergen.nl/~NYSEEuronext/TIWorkshop2009/Papers/BoehmerJonesZhang2009.pdf>) show that the stocks on the SEC restricted list suffered a “severe degradation” in market quality as measured by spreads, price impacts, and intraday volatility.
7. FSA Statistical analysis (Annex 2 of DP09/1, February 2009) shows that in relation to the FSA’s temporary short selling ban there was a marked decrease in trading volume and a widening of bid-ask spreads for the restricted shares. Moreover, one alleged criticism of short selling is that it may amplify price declines forcing stock prices below their fundamental value. If this were true, a ban on short selling would therefore reduce extreme negative returns for restricted shares. However, the FSA did not find any evidence that their short selling ban had reduced extreme negative returns for the restricted shares. Additionally, the FSA found no link between negative abnormal stock returns and the level of stock lending.
8. Oliver Wyman report (*The effects of short-selling public disclosure regimes on equity markets: A comparative analysis of US and European markets*, 2010, [http://www.oliverwyman.com/ow/pdf\\_files/OW\\_EN\\_FS\\_PUBL\\_2010\\_Short\\_Selling.pdf](http://www.oliverwyman.com/ow/pdf_files/OW_EN_FS_PUBL_2010_Short_Selling.pdf)) concludes that in markets subject to public short selling disclosure requirements (SSDR), liquidity provided by short sellers is impaired due to the combined effects of both a lack of willingness of investors to disclose short interest and a reduction in market capacity to support short selling. They estimate that public SSDRs decrease short sellers’ participation in equity markets by approximately 20 – 25%. This finding is confirmed both by the use of a short interest ratio as well as by proprietary data sourced from sell-side institutions. As short selling liquidity decreases there are material impacts to the markets for the affected securities as trading volumes decrease, bid-ask spreads widen, price discovery becomes less efficient and intraday volatility increases.

When considering whether to implement a short selling regime and the scope the regime should take, we would strongly urge that the differences between equity and corporate and sovereign bond markets be fully taken into account. A regime that is engineered and appropriate for the equity markets may not be appropriate for the corporate bond or sovereign bond markets. This is because corporate and sovereign bond markets work in a completely different way to equity markets. Not only are corporate and sovereign bond markets dealer markets (as opposed to equity markets which are order driven markets) but liquidity in corporate bond and sovereign bond markets is far thinner than for equity markets. For example, analysis (see attached) of Xtrakter's trading data for 2008 shows that for the **top 100** corporate bonds (by volume traded) the highest trade count bond traded 10,000 times in the year (very liquid) but the lowest only traded six times in the whole year. One of the main reasons for this divergence between equity and bond markets has to do with the fact that most investors in bonds hold them till maturity.

Though the various academic studies cited above are largely in respect of shares, there is clearly a need for particular caution if the Commission should consider applying short selling restrictions and public disclosures of short positions to bond markets, which are so much more illiquid than equity markets. If short selling bans and public disclosures have the effect of damaging liquidity in highly liquid equity markets, then applying such regulations to bond markets could cause irreparable damage.

Accordingly, we feel the scope of the regime should be as limited as possible. We would also strongly urge that the scope of any regime should be clearly targeted at addressing existing market failures. The various academic studies cited above would tend to argue that not only is there no evidence of market failure, but applying short selling restrictions and/or public disclosures may actually give rise to market failures.

Nevertheless, our members do feel that regulators should have access to data on short positions for systemic risk and market abuse purposes. To this end, our members would support private reporting to regulators of short positions. However, in respect of sovereign bonds, safeguards would need to be put in place to ensure that there is no potential for abusing the information – i.e. that adequate and appropriate Chinese Walls are put in place between the regulator and the government department issuing the sovereign bond. If a government (as issuer of a sovereign bond) possessed information about the short positions of every player in the market, market participants could face a significant competitive disadvantage.

Given the conclusions of the Oliver Wyman report cited above, the risks of public disclosure of short positions far outweigh any potential benefits and accordingly, we would urge the Commission not to adopt this element of the proposal.

The consultation also asks for views on the application of the regime to transactions carried on outside the EU. In considering this issue, we would ask that the Commission not place EU market participants at a competitive disadvantage. To this end, we would strongly urge the Commission to work with other jurisdictions to ensure that the potential for regulatory arbitrage is limited to the fullest extent possible. Accordingly, we feel that any requirements should be applied extra-

territorially to instruments admitted to trading on a venue within the EU, which would ensure consistent treatment for investors both within and outside the EU.

The consultation also asks for views on uncovered short selling. In our view, the risk that uncovered short selling leads to unsettled transactions which contribute to systemic risk is minimal. Failed trades are not a widespread problem in the EU and to the extent that failed trades are proving problematic, the solution is to improve the interconnectivity between the CSDs and the ICSDs across Europe. To the extent that there is “abusive” uncovered short selling (i.e. where the seller has no intention of borrowing and delivering the securities he has sold short) the appropriate remedy is enforcement action under the relevant market abuse regulations.

Views have also been sought regarding possible buy-in rules. The ICSDs currently offer an automatic securities lending facility, which plays a very useful role on reducing delivery failures in the cross-border market. Extending such facilities throughout the settlement/clearing network would be a welcome step.

If the Commission nevertheless decides to introduce a public disclosure regime or an uncovered short selling ban, we would strongly request an exemption for market makers (defined in accordance with the MiFID definition). However, we would urge that a market maker exemption be crafted so that if a firm satisfies the definition of market maker it need not additionally be required to assess every transaction for the transaction to qualify for the exemption. To do so would impose a very heavy cost on firms wanting to take advantage of the exemption.

We hope that you will find these comments useful. Moreover, we would be very happy to discuss this response with you further if that would be helpful.

Yours truly,

A handwritten signature in black ink, appearing to be 'Lalitha Colaco-Henry', written in a cursive style.

Lalitha Colaco-Henry

# Bond Analysis - 2008

## Caveats:

- Draft data presented for discussion purposes only.
- All data referred to within this document pertains to the most traded corporate bonds.
- Some double counting within the data (e.g. a Trax matched IDB brokered trade would count as 2 transactions). Xtrakter estimate this at approx 10%, all executed volume figures have been adjusted down to compensate.
- Data may contain repo transactions – Xtrakter are working to remove them

## Total Universe

Xtrakter provided the full year 2008 summary data for the ~10,000 bonds with the highest executed volume for the full year

This split between bond types as follows:

	<b># Instruments</b>
Corps	5671
Govt	3396
Mtge	696
Pfd	1
NotInBBG	81
<b>Total</b>	<b>9845</b>

As expected the highest turnovers were seen on the government bonds, with corporate bonds making up half of the top 10k instruments. The following analysis is focussed on those 5671 corporate bonds only.

The aim of this analysis is to provide a factual basis to facilitate discussions amongst the FSA Corporate bond working group. We have leveraged the existing matrix for equities Mifid reporting to provide a well understood framework for assessing the relative liquidity between the two products and hence a starting point for discussing appropriate delays to protect capital at risk.

We have also focussed on measures to help assess the population of bonds for which disclosure would (most likely) not harm liquidity. It suggests that no single measure provides a definitive assessment and, given the risks associated with that downside, highlights that an appropriate framework is critical. Measures such as %age turnover, total volume and trade count could be used in combination to provide an acceptable range.

### **Total liquidity Compared with Equities**

To provide a high level comparison of the relative liquidity of corporate bonds vs equities we looked at the average volume executed vs the issue size (amount of shares issued for equities): %age turnover.

Note: we are only considering the most liquid bonds vs the total European equity activity. A like for like comparison would therefore show a much lower turnover for bonds, but as the transparency initiative is focussed on the most liquid instruments we felt this was a fair comparison.

The average equity turnover was 257% vs 121% for bonds – clearly highlighting the liquidity differential

### **Top 5700 corporate bonds Full Year 2008** (EUR notional, 10% double count removed)

Notional Traded	6,186,782,284,537
Issue Size	5,114,392,030,433
%Notional/Issue Size	121%

Only 1000 of the corp. bonds achieve the average annual equity %age turnover of 257%

Turnover (%) *	Number of Bonds
	Total
100+	2737
200+	1445
257+	<b>1073</b>

### **FESE Equity Full Year 2008**

Data taken from the Federation of European Securities Exchanges website for equity trading volumes and ticket numbers for the full year of 2008:

Exchange	Value at Month End (EUROm)	On Exchange	Off Exchange	Total	Annual %age turnover	# Tickets
		Turnover (EUR m)	Turnover (EUROm)			
Athens Exchange	65,271	64,781	13,232	78,013	120%	9,390,164
Borsa Italiana	374,702	1,029,127	0	1,029,127	275%	69,293,592
Bratislava Stock Exchange	3,907	4	11	15	0%	2,169
Bucharest Stock Exchange	6,474	966	85	1,051	16%	800,888
Budapest Stock Exchange	13,326	20,916	51	20,967	157%	1,893,114
Bulgarian Stock Exchange	6,371	939	381	1,321	21%	388,821
Cyprus Stock Exchange	5,733	1,374	128	1,501	26%	414,550
Deutsche Börse	797,063	2,191,909	1,031,594	3,223,503	404%	141,913,900
Euronext	1,508,423	2,606,171	421,416	3,027,587	201%	191,760,218
Irish Stock Exchange	35,519	12,816	43,406	56,222	158%	1,263,352
Ljubljana Stock Exchange	8,468	971	634	1,605	19%	220,160
London Stock Exchange	1,352,327	2,601,411	1,760,787	4,362,198	323%	201,778,897
Luxembourg Stock Exchange	47,809	1,311	0	1,311		23,071
Malta Stock Exchange	2,567	49	0	49	2%	8,656
NASDAQ OMX Nordic	404,137	818,368	100,071	918,438	227%	55,543,264
Oslo Børs	101,982	275,916	32,252	308,168	302%	16,949,249
Prague Stock Exchange	29,615	33,764	415	34,179	115%	1,396,186
SIX Swiss Exchange	616,234	57,683	13,215	70,898	12%	6,916,219
Spanish Exchanges (BME)	680,632	1,243,167	411,392	1,654,558	243%	37,363,847
SWX Europe		899,556	53,474	953,030		35,113,602
Warsaw Stock Exchange	65,178	45,748	2,105	47,854	73%	9,839,800
Wiener Börse	54,752	71,851	0	71,851	131%	6,205,029
<b>TOTAL</b>	<b>6,180,491</b>	<b>11,978,797</b>	<b>3,884,647</b>	<b>15,863,444</b>	<b>257%</b>	<b>788,478,748</b>

<http://www.fese.be/en/?inc=art&id=4>

**Measures of Liquidity**

Total volume traded or %age turnover provide a good indication of liquidity, however as shown below neither taken in isolation provides a definitive measure.

**Trade Count:**

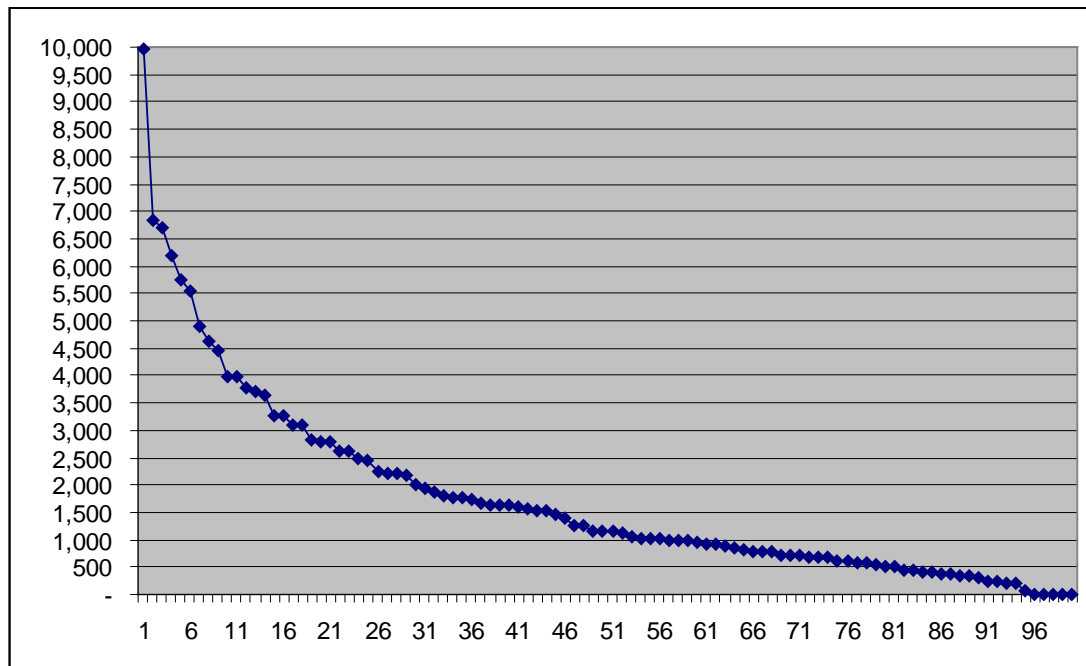
For example consider the actual numbers of transactions. If we take the top 100 bonds by volume traded:

Bond Rank (by Volume)	Range	Issue Size (% , EUR, 1.1)			Trade Counts		
		High	Av	Low	High	Av	Low
1 - 100		3,558	585	124	9,970	1,791	6

Within that top 100 bonds the highest trade count bond traded 10k times in the year (very liquid), but another only traded 6 times in the full year – clearly not liquid or, at the very least, an instrument where liquidity would be harmed by disclosure.

As the chart below highlights, the trade count within the Top 100 volume bonds rapidly drops down to the 1-2 trades a day level. So even within the extremely small universe of the top 100 by volume there are bonds that would be classed as illiquid or very illiquid. Any comparison with equity ticket numbers (see # tickets column in the FESE data) simply reiterates that concern.

Trade count for the Top 100 Volume Traded Bonds (sorted by trade count)



To show that distribution across a wider universe of bonds (ranked by volume executed)

Data							
Rank	Max %age	Av %age	Min %age	Max TCount	Av TCount	Min TCount	Total Volume
1-1000	5824%	339%	25%	9970	1032	5	3,733,828,340,953
1001-2000	2034%	160%	12%	4909	594	5	1,008,002,460,371
2001-3000	1182%	132%	12%	4589	449	4	584,156,917,164
3001-4000	2364%	132%	8%	2610	345	4	399,338,165,998
4001-5000	8361%	124%	6%	2560	257	4	289,134,499,656
5001-6000	1804%	112%	6%	1776	197	4	147,428,457,229
Grand Total	8361%	170%	6%	9970	496	4	6,161,888,841,371

If we consider the Top 1000 bonds by volume executed we again see bonds that by either %age turnover or Trade Count measures would be considered illiquid.

In addition if we rank the bonds by trade count alone, it highlights that of the top 6000 bonds by volume only half trade at least once a day. We would suggest that a bond should trade noticeably more frequently than that if we want to minimise the potential impact on liquidity or capital at risk.

Bond Rank	Trade Count
100	2,630
1000	853
2000	430
3000	242
4000	125
5000	27

### Issue Size

Generally the larger issues are more liquid, but again in isolation it does not provide a reliable measure of liquidity:

		%age			Trade Count			Volume executed	
Rank	IssueSize	Max	Av	Min	Max	Av	Min	Total Volume	MarketShare Vol
1-1000	0-500mm	5824%	849%	289%	2,204	615	5	206,286,837,195	4%
	>500mm	3558%	272%	25%	9,970	1,088	6	3,328,407,714,796	58%
1001-2000	0-500mm	2034%	330%	146%	2,078	470	5	214,625,229,738	3.73%
	>500mm	262%	96%	12%	4,909	630	12	717,884,182,315	12.47%
2001-3000	0-500mm	1182%	221%	96%	4,589	386	4	183,843,995,255	3.19%
	>500mm	135%	63%	12%	3,013	490	6	344,336,998,548	5.98%
3001-4000	0-500mm	2364%	211%	68%	2,227	263	4	161,465,896,945	2.81%
	>500mm	88%	46%	8%	2,610	424	4	206,791,261,661	3.59%
4001-5000	0-500mm	5786%	166%	49%	2,137	233	4	134,597,511,762	2.34%
	>500mm	62%	33%	6%	1,889	280	4	121,838,823,995	2.12%
5001-6000	0-500mm	1804%	151%	41%	1,264	173	4	81,791,775,441	1.42%
	>500mm	45%	27%	6%	1,634	226	4	52,720,152,848	0.92%
Grand Total		5824%	157%	6%	9,970	503	4	5,754,590,380,499	100.00%

This chart shows bonds issued in EUR, GBP and USD only – issue size in CCY, Vols in EUR equivalents (hence does not compare exactly with the above data)



Ranked by volume executed it is then further split by issue size. Again you can see that even in the top 1000 bonds by volume with an issue size >500mm we are seeing instruments that only traded 6 times in the year or others that had a %age turnover of only 25% – by the equity measure illiquid, by trade count highly illiquid and hence likely to suffer reduced liquidity if disclosed.

### **Other considerations**

Bonds are generally most liquid in the period shortly after issuance. Even large issue size bonds can quickly fall illiquid a few months after issuance, highlighting again that issue size alone is not a good indicator of liquidity.

Transaction Size: As we only have full year totals it was not possible to analyse transaction size.

### **Summary**

As previously discussed, to minimise the potential for damage to liquidity, a corporate bond disclosure regime needs to focus on the most liquid bond population as they are least susceptible to this risk.

Leveraging the equity Mifid framework and measures highlights the relatively lower liquidity of the bond market and hence provides a starting point for discussing appropriate delays to protect capital at risk and hence liquidity

Liquidity by it's nature is difficult to assess and none of the individual measures considered here provide a simple deterministic benchmark, for that reason we are of the view that multiple tests such as volume executed, %age turnover and ticket numbers should be taken into consideration when determining the most liquid population.