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REGULATING SHORT SELLING IN EUROPE AFTER THE CRISIS

Rodolphe B. Elineau[*]

Abstract

Short selling contributes to the efficient functioning of capital markets. While bullish investors tend to hold long positions, bearish investors act on information by shorting stock, thereby fostering the incorporation of good and bad information into stock prices. Yet short sellers are ill-viewed by corporate officers, directors, and financial market authorities. In the midst of the 2008 global financial crisis, several financial market authorities in the European Union issued emergency orders to crack down on short sellers, which resulted in a fragmented approach to short selling and created a case for regulatory action at the European Union level. This Article reviews the Regulation of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps. While the need to shed light on short selling further supports the need for regulatory action, there appears to be some cause for concern as "government hubris" might be destructive.

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"*They say 'there are no atheists in foxholes.'*
Perhaps, then, there are also no libertarians in crises."
James Frankel[1]

I. INTRODUCTION

A. The Mechanics of Short Selling

Short selling is commonly defined as the practice of selling a security the seller does not own at the time of the sale. A short seller can sell a security she does not own using the securities lending market. Two different strategies might be followed. In a covered short sale, the seller borrows or makes arrangements to borrow the security prior to the short sale. Conversely, in an uncovered or naked short sale, the seller neither borrows nor makes arrangements to borrow prior to the short sale but borrows and delivers the security to the buyer by the settlement date, usually three business days after the trade date. In both strategies, the short seller will close out the position by repurchasing and returning the same security to the lender.

The definition of short selling laid out in the Regulation on Short Selling and Certain Aspects of Credit Default Swaps (the Regulation) does not represent a departure from this widely accepted definition. Under Article 2(1)(b) of the Regulation, a

> "short sale" in relation to a share or debt instrument means any sale of the share or debt instrument which the seller does not own at the time of entering into the agreement to sell including such a sale where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement . . . .[2]

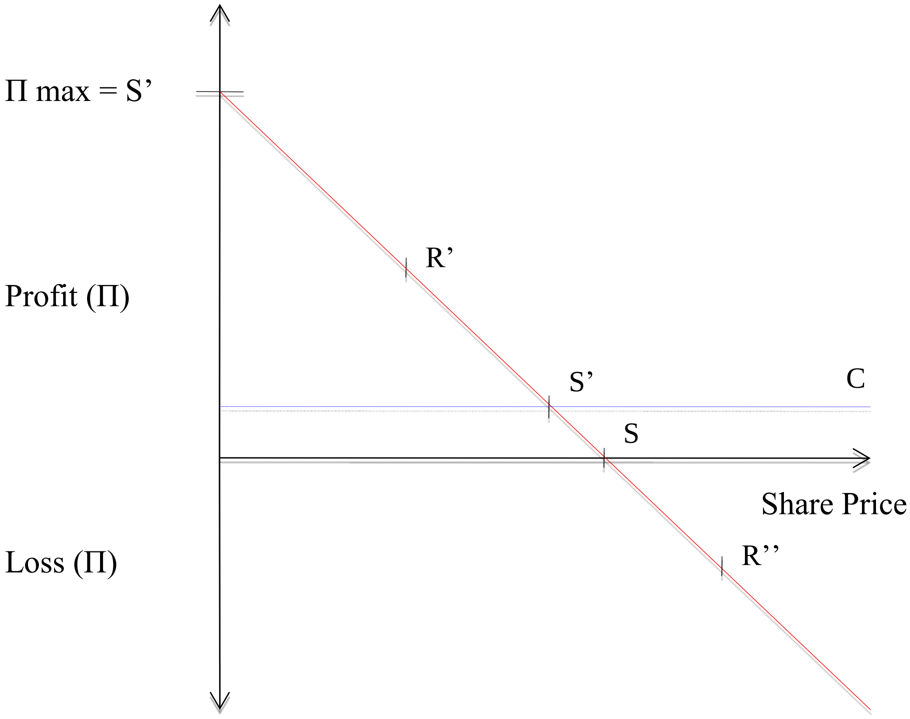
Likewise, Rule 200(a) of Regulation SHO, which sets forth the United States's regulatory framework governing short sales, refers to "any sale of a security which the seller does not own or any sale which is

[1] James Frankel, *Responding to Crises*, 27 CATO J. 165, 165 (2007).

[2] 2012 O.J. (L 87) 236/2012, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF [hereinafter *Regulation*].

consummated by the delivery of a security borrowed by, or for the account of the seller."[3]

A short seller makes a profit (Π) if she sells the borrowed security for a price (S) higher than what she pays to return the security to the lender (R): Π = S – R, as shown by the downward sloping curve in the graph below.



Short Sellers' Payoff Profile

The downward sloping curve makes it clear that short sellers expect stock prices to decline. Consider short selling a security for $S. The short seller will make a profit if she pays less than $S to return the security to the lender, for example $R', but suffer a loss if she pays more than $S to return the security to the lender, for example $R''. A short seller usually bears indirect costs (C) such as lending fees paid to the securities lender. As a consequence, a short seller must be able to cover these costs in order to earn a profit; that is, pay less than S' to return the borrowed security. Here, Π = S' − R, with S' = S − C.

[3] 17 C.F.R. § 242.200 (2012).

Short selling is highly risky. The outcome of such trading strategy relies on stock price evolution, and short sellers have limited upside potential profit but no downside protection. While the potential profit is capped at S (or S'), the potential loss is unlimited. Thus, short selling is much riskier than similar bearish strategies using put options, where both profits and losses are capped.

B. History of Short Selling and its Regulation

Short selling has always drawn the attention of regulators, particularly in the European Union. The first regulation on short selling was enacted in Holland in 1610. One year before in 1609, Isaac Le Maire, a Dutch businessman, founded a secret association—"Groote Company"—in order to short the shares of the Dutch East India Company in anticipation of the incorporation of a new rival French company,[4] sending the company's price into a plunge. Only eight years after the founding of the Amsterdam Stock Exchange, Dutch authorities outlawed all short sales.

Every crisis has unleashed political disdain for short sellers and prompted regulators to introduce curbs or outright bans on short selling. In 1932, Herbert Hoover, then-President of the United States, required an inquiry into short selling and expressed fears that "destructive short sellers" were "preventing an economic rebound."[5] In 1997, *Crédit Lyonnais*, a French bank, was blamed for short selling after the collapse of Malaysia's stock market and currency.[6] In the aftermath of the 2008 global financial crisis (the Crisis), critics of short selling are no different. Regulating short selling, which represents roughly 1 to 3 percent of market capitalization in Europe,[7] remains a stormy debate and a controversial issue.

[4] Arturo Bris, William Goetzmann, & Ning Zhu, *Efficiency and the Bear: Short Sales and Markets Around the World* (Yale ICF, Working Paper No. 02-45, 2004).

[5] RON CHERNOW, THE HOUSE OF MORGAN 351–52 (Grove Press ed., 2010).

[6] Daniel Trotta, *Short Sellers Have Been the Villain for 400 Years*, REUTERS, Sept. 26, 2008, *available at* http://www.reuters.com/article/2008/09/26/us-financial-shortselling-villainspics-idUSTRE48P7CS20080926.

[7] *Proposal for a Regulation on Short Selling and Credit Default Swaps*, MEMO/10/409 (Sept. 15, 2010), *available at* .http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/409&format=HTML&aged=1&language=EN&guiLanguage=en.

C. The E.U. Approach to Short Selling During the Crisis

The European Union's response to the recent financial crisis was disorganized and inconsistent across countries. At the height of the Crisis in September 2008, after the rescue of Bear Stearns and the bankruptcy of Lehman Brothers, regulators in several E.U. countries (Member States) issued temporary emergency orders as they grappled with how to deal with the Crisis. Indeed, they decided to crack down on bearish short sellers, which resulted in a fragmented approach to short selling across the European Union between 2008 and 2009.[8] These approaches included bans on the short selling of financial stocks,[9] bans on the short selling of all listed stocks,[10] bans on the naked short selling of financial stocks,[11] bans on the naked short selling of all listed stocks,[12] disclosure of net short positions in financial stocks,[13] and disclosure of net short positions in all listed stocks.[14]

The approach to short selling was also chaotic within some Member States, which added a sense of uncertainty to the Crisis that was roiling in the financial markets. In particular, Italy successively banned (i) naked short sales of financial stocks from September 23, 2008 to September 30, 2008; (ii) short sales of financial stocks from October 1, 2008 to October 9, 2008; (iii) short sales of all stocks from October 10, 2008 to December 31, 2008; (iv) short sales of financial stocks and stocks of companies increasing their outstanding share capital from January 1, 2009 to January 31, 2009; (v) naked short sales of all stocks from January 1, 2009 to July 31, 2009; (vi) short sales of financial stocks and stocks of companies increasing their outstanding share capital from February 1, 2009 to May 31, 2009; and (vii) short sales of stocks of companies increasing their outstanding share capital from June 1, 2009 to July 31, 2009.[15]

[8] Seraina Gruenewald, Alexander Wagner & Rolf Weber, *Emergency Short Selling Restrictions on the Course of the Financial Crisis* (June 22, 2010)(unpublished working paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1441236.

[9] Austria, Belgium, France, Germany, Italy, Luxembourg, and Portugal. *Id.* at 7–13.

[10] Italy and the Netherlands. *Id.* at 11–13.

[11] Denmark, Ireland, Italy, the Netherlands, Norway, and the United Kingdom (the "UK"). *Id.* 9–16.

[12] Austria, Greece, and Italy. *Id.* at 7–11.

[13] Belgium, France, Germany, Ireland, Portugal, Spain, and the UK. *Id.* at 8–16.

[14] Greece, Hungary, and Spain. *Id.* at 10, 15.

[15] The ban was extended *sine die* on August 1, 2009. *See* CONSOB Resolution No. 16971 (July 28, 2009), *available at* http://www.consob.it/mainen/documenti/english/resolutions/res16971.htm.

Moreover, these temporary emergency orders might well have been illegal in some Member States. Particularly, Bonneau argued that the French Autorité des Marchés Financiers (AMF) had no legal authority to ban short selling activity during the crisis.[16] Lawyers tend to think that issues of legal authority do matter, even in the midst of a severe global financial crisis, and such a dismissive attitude raised some concern.

D. The E.U. Regulatory Approach in the Aftermath of the Crisis.

During the aftermath of the Crisis, regulatory agencies tried to create a more consistent approach to short selling. On March 14, 2012, the Regulation on Short Selling and Certain Aspects of Credit Default Swaps was adopted by the European Parliament and the Council. The Regulation aimed at harmonizing the rules applicable to short selling across the European Union and clarifying the powers of competent regulators. To that purpose, the European Commission and the European Parliament used a regulation, which is binding in its entirety and directly applicable in all Member States, as opposed to a directive, which is only binding as to the result to be achieved and leaves to the national authorities the choice of form and methods.[17] The Regulation is enforceable throughout the European Union, without the need for further legal thinking by any Member State. Cooperation between the European Commission and Member States has been crucial since the Regulation has been passed by the European Parliament and adopted by the Council in accordance with the ordinary legislative co-decision procedure.

[16] Thierry Bonneau, *Crise financière: l'AMF hors la loi... Pour la bonne cause*, 5 REVUE DE DROIT BANCAIRE ET FINANCIER [REV. DR. BANC. FIN.] 12 (2008)(Fr.). The French Banking and Financial Regulation Act, passed on October 22, 2010, entrusted the French AMF with the legal authority to prohibit short selling. On August 25, 2011, pursuant to article L. 421-16 of the French Monetary and Financial Code (*Code monétaire et financier*), the French AMF banned short selling of certain financial stocks (April Group, Axa, BNP Paribas, CIC, CNP Assurances, Crédit Agricole, E.U.ler Hermès, Natixis, Scor and Société Générale). The ban was extended for three months on November 11, 2011, pursuant to a decree of the French Ministry of Finance. Moreover, article 223-37 of the General Regulation of the AMF was amended. This article requires the notification to the AMF of any net short position that becomes equal or greater than 0.2, 0.3, or 0.4 percent of the capital of a company whose shares are admitted to trading on a regulated market or traded on an organized multilateral trading facility. Moreover, any short position that becomes equal or greater than 0.5 percent must be publicly disclosed, as well as any increments of 0.1 percent.

[17] *Consolidated Version of The Treaty on the Functioning of the European Union* art. 288, Mar. 30, 2010, 2010 O. J. (C 83) 171-72.

E. The U.S. Response to the Crisis

In contrast to the European Union's response, the U.S. Congress did not address the issue of short selling in a specific law or regulation, nor did it design a ready-to-use set of rules in the aftermath of the Crisis. Instead, the U.S. Securities and Exchange Commission (SEC) was given broad authority to regulate further short sale transactions by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law by President Obama on July 21, 2010. Particularly, Section 929X gives the SEC the authority to, *inter alia*, design new disclosure requirements and rules necessary or appropriate to ensure that the appropriate enforcement options and remedies are available against manipulative short selling. When relevant, this Article will compare the E.U. and U.S. approaches.

F. Short Selling and Market Efficiency

Short sellers are usually considered to be greedy speculators reaping the benefits of bearish financial markets at the expense of the general welfare. In particular, corporate officers and directors are hostile to short sellers. Richard Fuld, then-CEO of Lehman Brothers, was quoted as saying, "I will hurt the shorts, and that is my goal."[18] This statement, made a few months before the collapse of Lehman Brothers, gives an accurate sense of how ill-viewed short sellers are in the corporate community. Indeed, short selling conveys bad information to the markets about a particular security, worries long investors, and puts corporate officers and directors in the hot seat. Corporations often blame short sellers for their financial woes rather than admit management's flaws. Lamont studied the methods used by firms to impede short selling and prop up their stock price. These methods include soliciting legal actions from regulatory authorities and disrupting the securities lending markets to prevent would-be short sellers from borrowing stocks by using belligerent statements claiming that "short sellers are acting improperly to cause the stock price to go down."[19] Is short selling really a disruptive trading strategy hurting the formation of market stock prices? Not necessarily.

[18] Andrew R. Sorkin, *Lehman Brothers Takes on Rumors by 'The Shorts'*, N.Y. TIMES, July 8, 2008.

[19] Owen Lamont, *Go Down Fighting: Short Sellers vs. Firms* (Nat'l Bureau of Econ. Research, Working Paper No. 10659, 2004).

Academic literature provides strong evidence showing that short selling contributes to the efficiency of financial markets. Following Fama's insight, a market is efficient when prices "fully reflect available information."[20] Three different forms of market efficiency might be considered, depending on the types of information that are expected to be incorporated into stock prices: a "weak" form where a security's price reflects all information conveyed by past prices; a "semi-strong" form where a security's price reflects all publicly available information; and a "strong" form where a security's price reflects all available information, whether public or private.[21] Gilson and Kraakman explain that markets cannot be efficient in the "strong" form because the costs of acquiring private, non-public information are too high.[22] On the other hand, mandatory disclosure rules make information about an issuer available to investors at a very low cost. Investors act on information[23] and a security's price therefore reflects such publicly available information, strengthening the efficiency of financial markets in the semi-strong form.

There are also two aspects of market efficiency—informational efficiency and allocational efficiency. Informational efficiency describes how fast the information is incorporated into market prices. Allocational efficiency describes the best allocation of resources in the market.[24] Even though all investors are given the very same information through mandatory disclosure rules, investors have heterogeneous beliefs. While long investors can be seen as optimistic (they expect the price of a security to soar), short sellers can be deemed pessimistic (they expect the price of a security to fall). Following Miller's intuition, when investors disagree about the value of a security, any constraints on informed bearish short sellers leads to overpriced securities.[25] Without short sellers acting on bad information, a security's price does not fully reflect available information and financial markets can no longer be deemed

[20] Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (internal quotation marks omitted).

[21] *Id*.

[22] *See* Ronald Gilson & Reiner Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 607 (1984).

[23] Ray Ball, *The Global Financial Crisis and the Efficient Market Hypothesis: What Have We Learned?*, 21 J. APPLIED CORP. FIN. 8, 10 (2009) (This article argues that if investors do not act on information, the market would no longer be efficient. The argument that no one should act on information "confuses a statement about an equilibrium 'after the dust settles' and the actions required to obtain that equilibrium.").

[24] JAMES COX, ROBERT HILLMAN & DONALD LANGEVOORT, SECURITIES REGULATION – CASES AND MATERIALS 107 (Aspen Publishers ed., 2009).

[25] Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151, 1162 (1977).

efficient. Therefore, promoting short selling is a way to promote market efficiency. Moreover, most research also suggests that short sales ensure a smooth functioning of financial markets. Particularly, short sellers create liquidity when they sell, borrow, and repurchase securities on the market. Market makers also use short selling to fill clients' orders with respect to securities that are not immediately available and thus provide liquidity to the market. Short selling is also a commonly used hedging strategy that insures the rest of a given portfolio against a decline in stock prices. Finally, by giving the opportunity to pessimistic investors to act on information, short selling mitigates the formation of market bubbles.

However, researchers in behavioral economics found that stock prices exhibit more volatility than suggested by the efficient market hypothesis. As Shiller put it, "[markets] contain quite substantial noise,"[26] putting the state of equilibrium in jeopardy. Markets may be prone to "irrational exuberance,"[27] and therefore be irrationally unstable. Regulation of short selling cannot ignore these critics.

G. The Case for Regulatory Action.

What is the rationale for government intervention? Why should short selling be regulated in the first place? There is no evidence that short sellers caused the Crisis or Lehman Brothers' end. On the contrary, with respect to Lehman Brothers, Warren Buffet suggested that blaming short sellers was indicative of a failure to admit one's own problem.[28] Likewise, Thomas Baxter, Jr., General Counsel of the Federal Reserve Bank of New York, saw good cause in shorting Lehman[29] and Richard Posner has argued that "there was not enough short selling to alert the market and the [U.S.] government to the weakness of the banks, in part because . . . short selling is a risky investment strategy."[30] However, the Crisis revealed at least one market failure that has to be fixed at the E.U. level—market participants did not take the appropriate steps to shed light on short selling. Opaqueness was a vast problem during the Crisis and

[26] Robert Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSP. 83, 90 (2003).

[27] *Id.*

[28] Report of Anton R. Valukas, Examiner, *In re* Lehman Brothers Holdings Inc., No. 08-13555, (JMP), at 665 (Bankr. S.D.N.Y. Mar. 11, 2010).

[29] *Id.*

[30] RICHARD POSNER, A FAILURE OF CAPITALISM – THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 147 (Harvard University Press ed., 2009).

prompted many regulators to intervene in their own jurisdiction. Regulating short selling at the E.U. level should harmonize the current fragmented approach without jeopardizing market efficiency. E.U. authorities should therefore shed light on short selling without discouraging short sellers or allowing interference with market allocation of resources. As Frankel put it:

> [C]rises should not become an excuse for public policy that is hasty or ill-informed, or that serves primarily the interests of the policymakers themselves or of special interests. The response must be appropriate and careful. It must be informed by the longer term perspective offered in the lessons of historical precedent, particularly regarding the fallibility of well-intentioned government intervention, and by an awareness of the dangers identified in the theory of moral hazard.[31]

Against this background, we can now examine the Regulation's approach. The Regulation takes a tough stance on short selling, arguing that it "could aggravate the downward spiral in the prices of shares, notably in financial institutions, in a way which could ultimately threaten their viability and create systemic risks."[32] More than four hundred years after the Dutch authorities outlawed short selling, E.U. lawmakers are still wary of short sellers. What it means for the efficiency of financial markets within the European Union is uncertain, but there appears to be some cause for concern.

II. IMPLEMENTATION OF ENHANCED TRANSPARENCY RULES

The Regulation promotes transparency of short selling using two different sets of rules: a two-tier disclosure regime of net short positions (A), and considering the marking of orders as short sales (B).

A. Two-Tier Disclosure Regime of Net Short Positions

[31] Frankel, *supra* note 1, at 165.

[32] The fear that short selling could create systemic risks is mentioned three times at the very beginning of the Regulation. *Regulation*, *supra* note 2, at

For companies whose shares are admitted to trading on a trading venue (that is, a regulated market or a multilateral trading facility[33] in the European Union), the Regulation provides for a two-tier model for transparency of net short positions relying on private notifications to the regulator and disclosures to the public. In comparison, since the expiration of "Form SH Order" on August 1, 2009,[34] the SEC is relying on several Self-Regulatory Organizations (SROs) to increase transparency surrounding short selling activity. SROs provide website disclosures with respect to daily aggregate short selling volume in each individual security and anonymized information regarding individual short sales transactions on a one-month delayed basis. The appointed SROs are BATS Exchange, Direct Edge Holdings, FINRA, International Securities Exchange, NASDAQ Stock Market, NASDAQ OMX BX, National Stock Exchange, New York Stock Exchange, NYSE Amex, and NYSE Arca. The SEC also discloses bimonthly the aggregate net balance of shares that failed to be delivered as of a particular settlement date. This fails-to-deliver data is disclosed on the SEC website for all equity securities.[35]

1. Prelude: What is a Net Short Position?

Under Article 3(4) of the Regulation, a net short position is obtained by deducting any "long position" from any "short position."[36] Holding a share creates a long position while short selling a share creates a short position. The Regulation goes further to prevent traders from

[33] *See* Article 4(1)(15) of the Directive 2004/39 of the European Parliament and of the Council of April 21, 2004 on Markets of Financial Instruments, explaining that "multilateral trading facility" means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments—in the system and in accordance with non-discretionary rules—in a way that results in a contract in accordance with the provisions of Title II [of the Directive].

[34] On September 18, 2008, the SEC issued an emergency order, the "Form SH Order." Form SH required institutional investment managers that exercise "investment discretion" with respect to accounts holding "section 13(f) securities" (*i.e.*, equity securities of a class described in section 13(d)(1) of the Act that are admitted to trading on a national securities exchange or quoted on the automated quotation system of a registered securities association) having an aggregate value of at least $100,000,000 to file Form SH with the SEC. Form SH was filed electronically on the last business day of every week immediately following a week in which the manager effected short sales. Form SH required the disclosure of the gross number of the securities sold short during the day.

[35] The short sale volume and transaction data are available at http://www.sec.gov/answers/shortsalevolume.htm. The fails-to-deliver data are available at http://www.sec.gov/foia/docs/failsdata.htm. Press Release, U.S. Sec. & Exch. Comm'n, SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency (July 27, 2009), *available at* http://sec.gov/news/press/2009/2009-172.htm.

[36] *Regulation*, *supra* note 2, art. 3(4).

circumventing the law using options, futures, contract for differences, and credit default swaps, even if such alternative strategies are usually costlier for traders. Therefore, entering into a transaction which creates or relates to a financial instrument and confers a financial advantage in the event of a decrease (or increase) in the price of the share is deemed to create a short (or long) position.[37] As a consequence, traders will not be able to use strategies based on the put-call parity (which involves buying a put, writing a call, and selling a bond to obtain the same payoff as shorting a security in efficient capital markets).[38] The transparency regime is also designed to cover over-the-counter short selling, as long as a net short position is created with respect to shares admitted to trading on a trading venue in the European Union. Appropriately, the two-tier disclosure regime applies whether short sellers, either natural or legal persons, are residing or established within or outside the European Union.

Short sellers are required to quickly notify or disclose net short positions. The calculation of a net short position shall be made at midnight at the end of the trading day and the notification or disclosure shall be made by 15:30 hours (3:30 p.m.) on the next trading day.[39] Such a short notice requirement seems fundamental because a lot of short positions are short term and the notification or disclosure of closed-out short positions is of little interest. In the notification or disclosure form, short sellers shall list their identity (more on this later), the size of the relevant position, the targeted issuer, and the date on which the relevant position was created, changed, or ceased to be held.[40]

This transparency model does not apply to all short sales in shares. First, it does not apply to shares admitted to trading on a trading venue in the European Union when the principal venue for the shares (that is, the venue with the highest turnover) is outside the European Union.[41] Second, it does not apply to market-making activities, pursuant to which an investment firm or credit institution acts as principal in a financial instrument.[42] Market-making activities include (i) posting firm, simultaneous two-way quotes of comparable size and at competitive

[37] *Id.* arts. 3(1)–3(2).

[38] $C(t) + K.B(t, T) = P(t) + S(t)$; And $-S(t) = P(t) - C(t) - K.B(t)$, With: $C(t)$ the value of the call at time t, $P(t)$ the value of the put at time t, $S(t)$ the value of the security, K the strike price, $B(t, T)$ the value of the bond maturing at time T.

[39] *Regulation*, *supra* note 2, art. 9(2).

[40] *Id.* art. 9(1).

[41] *Id.* art. 16(1).

[42] *Id.* art. 17(1).

prices, with the result of providing liquidity on a regular and ongoing basis to the market; (ii) fulfilling orders, as part of the usual business, initiated by clients or in response to clients' requests to trade; and (iii) hedging positions arising out of those dealings.[43]

Third, it does not apply to short sales entered into or net short positions created in relation to the carrying out of a stabilization scheme under a specific commission regulation.[44] This regulation emphasizes that "stabilization transactions mainly have the effect of providing support for the price of an offering of relevant securities during a limited time period if they come under selling pressure, thus alleviating sales pressure generated by short term investors and maintaining an orderly market in the relevant securities."[45] Since short selling does not provide support for a security's price, does this exemption really make sense? During a significant offering, when the number of relevant securities is not sufficient to satisfy all potential investors, an underwriter can, as provided in the underwriting agreement, short sell the relevant securities so that the underwriter could accept a number of purchases greater than the number of securities initially offered (overallotment facility). The underwriter is at risk like any short seller if the price of the securities soars. However, such risk is limited because the issuer usually grants the underwriter an option to purchase up to a certain amount of relevant securities at the offer price for a certain period of time after the offer (a green shoe option). The exercise of overallotment and green shoe options are deemed "ancillary stabilization."[46] Therefore, short sales can be part of a stabilization scheme and the exemption of the Regulation makes sense.

2. *Notification of Net Short Positions*

Article 5 of the Regulation requires a short seller who has a net short position to notify the relevant competent authority whenever this position reaches or falls below 0.2 percent of the issued share capital of the company. A short seller shall also provide notification for every increment of 0.1 percent by which the position increases. The relevant

[43] *Id.* art. 2(1)(k).

[44] Commission Regulation 2273/2003, Implementing Directive 2003/6/EC of the European Parliament and of the Council as Regards Exemptions for Buy-Back Programmes and Stabilisation of Financial Instruments, art. 2(12), 2003 O.J. (L 336) 33, 35.

[45] *Id.* at 34.

[46] *Id.* at 35.

competent authorities are to be officially designated by each Member State for the purpose of the Regulation.[47]

This notification should be of great interest for financial market authorities. It will provide them with adequate data to monitor short selling and bring enforcement actions under the Market Abuse Directive.[48] This notification system will also enable financial market authorities to compile statistics about short selling. The data will be accurate because the notification requirement covers net short positions created by trading shares not only on trading venues but also on over-the-counter markets. Moreover, notification of net short positions, which take into account long positions used to close out short sales, is more accurate than the disclosure of gross short positions in assessing the potential risks stemming from short sellers' activity. The costs associated with this notification requirement could be dissuasive and limit short selling activity. However, short sellers already calculate their net short positions for the purpose of monitoring risks and exposure. Even though short sellers could be required to amend their calculation methods to comply with the Regulation, marginal costs would be limited and largely outweighed by the benefits derived from the notification requirement.

3. Public Disclosure of Net Short Positions

Article 6 of the Regulation requires short sellers who have a net short position to publicly disclose details of the position whenever it reaches or falls below 0.5 percent of the issued share capital of the company. Each 0.1 percent above that threshold shall also be disclosed to the public. This disclosure threshold is much lower than the disclosure threshold for long positions, which is set at 5 percent in both the European Union[49] and the United States.[50]

Public disclosure of net short positions by short sellers will lower the information acquisition costs of other market participants. Following

[47] *Regulation*, *supra* note 2, art. 32. Certainly, the French AMF, the German Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin), the Spanish Comision Nacional del Mercado de Valores (CNMV), the Italian Commissione Nazionale per le Società e la Borsa (CONSOB), the Hellenic Capital Market Commission (HCMC), etc.

[48] Directive 2003/6 of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16.

[49] Directive 2004/109 of the European Parliament and of the Council of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, art. 9.1, 2004 O.J. (L 390) 38, 47.

[50] Securities Exchange Act of 1934, 15 U.S.C. § 78m(d)(1) (2011).

Gilson and Kraakman, this will strengthen market efficiency in its semi-strong form. The incorporation of information into market prices will become faster because whenever a net short position held by a short seller reaches or falls below the 0.5 percent threshold, all other market participants will receive this information the following business day and will be able to act on this information.

Still, such a requirement raises some serious concerns. Since short sellers must disclose their identity, a herdlike behavior will arise (that is, the disclosure of well-known managers' positions will lead other market participants to adopt the same strategy). This irrational aspect of financial markets is well-developed in behavioral finance as a critique of the efficient capital market hypothesis. In his seminal book, Shiller explains how "[such] behavior, although individually rational, produces group behavior that is, in a well-defined sense, irrational."[51] As a result, all market participants will follow the trend set by star managers, and market movements will no longer reflect the fundamental value of companies' equity.

Furthermore, public disclosure of net short positions and identification of short sellers will facilitate retaliation by issuers, including belligerent statements, legal actions, and short squeezes, even when short selling is justified by the underlying financial situation of any given company. Such risks would deter short sellers from acting and would undermine market efficiency. As a result, investors will invest less in markets where public disclosure is required and begin to allocate capital to markets "with more palatable regulatory frameworks."[52] The fear that regulation will unduly interfere with market allocation of resources materializes here.

An alternative solution was suggested by the AIMA[53] and in the Report of the European Parliament that could have alleviated these fears without calling into question the benefit of public disclosure for market efficiency. The alternative solution was that the public disclosure of net short positions should not identify the holder of the net short position (that is, the public disclosure should be made in an anonymous form).

[51] ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (Princeton University Press ed., 2005).

[52] Oliver Wyman, *The Effects of Short Selling Public Disclosure Regimes on Equity Markets – A Comparative Analysis of US and European Markets* at 29 (2010), *available at* .http://www.oliverwyman.com/ow/pdf_files/OW_EN_FS_PUBL_2010_Short_Selling.pdf.

[53] Alternative Investment Management Association, *Position Paper on the European Commission's Proposal for a Regulation on Short Selling and Certain Aspects of Credit Default Swaps*, 7 (Dec. 2010) (position paper), *available at* http://www.aima.org/en/knowledge_centre/regulatory-and-tax/position-papers.cfm.

Indeed, this solution could have alleviated the fears of herding and retaliation.

B. Toward the Implementation of a Marking Regime?

In addition to the transparency regime, the Commission is invited to consider, in the context of the revision of the Markets in Financial Instruments Directive, whether inclusion by investment firms of information about short sales in transaction reports to competent authorities would provide useful supplementary information to enable competent authorities to monitor levels of short selling. Such a requirement would enable market authorities to gain information about intraday short sales.

In the United States, Rule 200(g) of Regulation SHO requires brokers or dealers to mark all sell orders of any equity security as "long," "short," or "short exempt."[54]

The implementation of a marking regime would raise serious concerns. The benefits stemming from such a requirement are limited because the requirement does not cover over-the-counter short sales and cannot be used to evaluate the outstanding short positions in the market or spot any large short position.[55] The picture will be incomplete and misleading. Moreover, the implementation of a marking regime will be highly costly. According to the UK Financial Services Authority (FSA):

> [W]ork carried out by the FSA indicates that a flagging regime would be prohibitively expensive to introduce. The limited benefits that it would bring would not justify the very high implementation and compliance costs (which could be as high as £2m per firm according to responses to a survey we conducted in 2009).[56]

These costs will be particularly high in the European Union because only Greece already has the infrastructures required to implement a marking

[54] 17 C.F.R. § 242.200(g) (2012).

[55] Report of Committee of European Securities Regulators, *Model for a Pan-European Short Selling Disclosure Regime*, at 6, CESR/10-088 (Mar. 2010), *available at* http://www.esma.europa.eu/system/files/10_088.pdf..

[56] Alternative Investment Management Association, *supra* note 49, at 8.

regime. The costs will be high for both short sellers and trading venues.[57] A marking regime does not withstand a sensible cost-benefit analysis.

III. REGULATION OF UNCOVERED OR NAKED SHORT SALES

The Regulation requires all short sellers to comply with a "locate" requirement (A). Moreover, the Regulation designs specific buy-in procedures (B).

A. "Locate" Requirement

Under Article 12 of the Regulation, a short seller may enter into a short sale only of a share admitted to trading on a trading venue if (i) she borrowed the share or made alternative provisions resulting in a similar legal effect; (ii) she entered into an "agreement" to borrow the share or has another absolutely enforceable claim under contract or property law to obtain ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due; or (iii) she has confirmed that the share has been located and took "measures" vis-à-vis a third party necessary to have a "reasonable expectation" that settlement can be effected when it is due.[58]

When, prior to a short sale in shares, a short seller borrowed the share or entered into an agreement to borrow the share, the short sale is "covered" and there is no settlement risk. On the other hand, when a short seller has "reasonable expectation" that settlement can be effected only when it is due, the short sale is "uncovered" or "naked," and there is settlement risk on delivery date. Under this "locate" approach, a short seller shall perform the "locate" prior to executing a short sale, and a corresponding "locate" shall be matched to each short sale. Initially, the European Commission considered the implementation of a "locate and reserve" requirement pursuant to which a short seller must at least have an arrangement with a third party under which the third party has confirmed that the share has been located and reserved for lending. The implementation of such requirement would have outlawed uncovered or naked short selling, usually classified as manipulative *per se* because short sellers can short sell more than 100 percent of the issued share

[57] Committee of European Securities Regulators, *supra* note 50, at 6.
[58] *Regulation*, *supra* note 2, art. 12.

capital of a company, dramatically increasing the downward pressure on a particular security and the risk of settlement failures.[59]

The manner in which short sellers could satisfy the "reasonable expectation" requirement will be determined by the European Securities and Markets Authority (ESMA), taking into account the intraday trading and the liquidity of the shares. In the United States, Rule 203(b)(1) of Regulation SHO, which requires broker-dealers to borrow or "locate" securities before any short sales, allows reliance upon blanket assurances or so-called "easy to borrow" lists to comply with the locate requirement without directly contacting the source of the borrowed security.[60]

Naked short selling is not outlawed. However, manipulative or abusive naked short selling is still subject to investigation and enforcement actions brought by regulators pursuant to the Market Abuse Directive.[61] As Gruenewald, Wagner, and Weber observed, "naked short selling is not actually a special case compared to conventional short selling in terms of its economic implications" and does not require specific regulatory impediments.[62]

Moreover, there is no need to rule out non-manipulative and non-abusive short selling because the risk of settlement failure is efficiently addressed by buy-in procedures and fines for late settlement.

B. Buy-In Procedures

Under Article 15 of the Regulation, a central counterparty in a Member State that provides clearing services for shares shall monitor whether a short seller fails to deliver the shares within four business days after the day on which settlement is due. If not, procedures are automatically triggered for the buy-in of the shares to ensure delivery for settlement. When the central counterparty is not able to buy-in the shares, an amount is paid to the buyer based on the value of the shares to

[59] *Id.*

[60] 17 C.F.R. § 242.203(b)(1) (2012). In the draft implementing technical standards submitted by the ESMA to the Commission, the ESMA also referred to "easy to borrow" shares.

[61] Seraina Gruenewald, Alexander Wagner, & Rolf Weber, *Short Selling Regulation after the Financial Crisis – First Principles Revisited*, 7 INT'L J. DISCLOSURE & GOVERNANCE 108, 129 (2010).

[62] *Id*. at 129–30. However, in addition to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the SEC adopted Rule 10b-21, a naked short selling antifraud rule. Under Rule 10b-21, it is unlawful for any person to submit an order to sell a security if that person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding his/her intention, or ability, to deliver the security by settlement date and that person fails to deliver the security by settlement date.

be delivered at the delivery date, plus an amount for losses incurred by the buyer as a result of the settlement failure. The short seller will reimburse all amounts paid.

These buy-in procedures are not an incentive for short sellers to recklessly engage in naked short selling because short sellers who fail to deliver the shares by the settlement date have the obligation to make daily payments for each day the failure continues. These payments or fines for late settlement "shall be sufficiently high to act as a deterrent to natural or legal persons failing to settle."[63] The buy-in procedures and fines will efficiently deter naked short sellers from failing to deliver because they will be worse off once the central counterparty acts.

In the United States, close-out requirements focus on participants of a clearing agency and broker-dealers. Under Rule 204(a) and (b) of Regulation SHO, if a participant of a registered clearing agency has a "fail to deliver"[64] relating to a short sale with respect to any equity securities, the participant must immediately close out the position by either borrowing or purchasing the shares before the beginning of trading hours on the first settlement day after the settlement date. Moreover, the participant and any broker-dealer from which it receives trades become subject to the so-called "pre-borrow penalty."[65] This requires the participant to first borrow or arrange to borrow the security before accepting any short sales orders or effecting short sales for its own account in the security, until the "fail to deliver" is closed out by purchasing (not borrowing) the relevant security. Because Rule 204 applies to all equity securities, it eliminates the close-out requirement for "threshold securities" (that is, securities that experience large and persistent failures to deliver) under Rule 203(b)(3) of Regulation SHO.[66]

Buy-ins and fines for late settlement are necessary to mitigate risks of settlement failure resulting from "naked" short sales. Moreover, relying on buy-in procedures and fines for late settlement is a better alternative to prevent settlement disruption than an outright ban on "naked" short selling through the implementation of a "locate and reserve" requirement. First, the "locate and reserve" requirement would restrict all naked short sales whereas the buy-in procedures and fines discriminate by targeting only short sellers who fail to deliver. Second, the "locate and reserve" requirement would "suck liquidity out of the

[63] *Regulation*, *supra* note 2, art. 15(2).
[64] 17 C.F.R. § 272.204 (a)–(b)
[65] *Id.*
[66] *Id.*

market, pushing up the cost of borrowing, leading to hoarding of securities."[67] Every short seller contemplating a covered or naked short sale would suffer from this liquidity drain and escalation in borrowing costs. On the other hand, the buy-in procedures and fines are painful only for short sellers who fail to deliver. Third, even if the buy-in procedures are costly for a buyer who faces the risk of late delivery or cash compensation instead of delivery of the purchased security, the costs of the "locate and reserve" requirement would be far greater for both short sellers (because of high borrowing costs, hoarding of security, and liquidity drain) and buyers (because of liquidity drain).

IV. IMPLEMENTATION OF CIRCUIT BREAKER RULES

Once circuit breaker rules are triggered by either "exceptional situations" or a "significant fall in price" (A), there is some cause for concern because of a foreseeable lack of coordination (B), and a potentially disruptive impact on the efficiency of financial markets (C).

A. Triggering Events: "Exceptional Situations" and a "Significant Fall in Price"

The Regulation implements new curbs to prevent short selling in battered stocks. In case of adverse events or developments ("exceptional situations" which constitute a serious threat to financial stability and market confidence) or a significant fall in price, the competent authority of each Member State has far-reaching powers of intervention to require further transparency or to impose restrictions on short selling.[68] In the European Commission's own words, adverse events or developments include "not just financial or economic events but also for example natural disasters or terrorist acts."[69] With respect to a significant fall in price, pursuant to Article 23(5) of the Regulation, a decline of 10 percent or more in the case of a liquid share shall be deemed a significant fall in price.[70]

[67] Alternative Investment Management Association, *supra* note 56, at 4.

[68] *Regulation*, *supra* note 2, art. 1.

[69] *Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps*, COM (2010) 482 final (Sept. 15, 2010), *available at* http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf.

[70] With respect to illiquid shares and other classes of financial instruments, the fall in value shall be an amount specified by the Commission.

In exceptional situations, the competent authority has the power to require further transparency of net short positions in relation to a specific financial instrument or class of financial instruments (of which transparency is not already required under Articles 5 to 8 of the Regulation) reaching or falling below a notification threshold fixed by the competent authority.[71] The competent authority may also prohibit or impose conditions relating to persons entering into a short sale or other transaction that creates, or relates to, a financial instrument that confers a financial advantage on the person in the event of a decrease in the price or value of another financial instrument.[72] These measures may apply to transactions concerning all financial instruments, financial instruments of a specific class, or a specific financial instrument.[73] Restrictions will be valid for an initial period not exceeding three months but will be renewable for further periods limited to three months at a time (Article 24 of the Regulation).[74]

Where the price of a financial instrument on a trading venue is experiencing significant downward price pressure, the competent authority shall consider whether it is appropriate to prohibit or restrict short sellers from engaging in short selling of the financial instrument on the trading venue or otherwise limit transactions in that financial instrument on that trading venue "in order to prevent a disorderly decline in the price of the financial instruments."[75] This measure applies for the rest of the day (First Trading Day) and the following day (Second Trading Day). If, at the end of the Second Trading Day, there is a further significant fall in value from the closing price of the First Trading Day (that is, 5 percent or more for liquid shares),[76] the competent authority may renew the measure for a further period of two trading days after the end of the Second Trading Day.[77]

On February 24, 2010, the SEC adopted a new circuit breaker rule (the so-called alternative uptick rule) that places price restrictions on short selling when a stock is experiencing significant downward price pressure. When a security's price declines by 10 percent or more from the prior day's closing price, Rule 201 of Regulation SHO prevents the

[71] *Regulation*, *supra* note 2, art. 18.

[72] *Id.* art. 20.

[73] *Id.*

[74] *Id.* art. 24.

[75] *Id.* art. 23.

[76] Or, with respect to illiquid shares, half or the amount specified by the Commission pursuant to Article 23(5) of the Regulation.

[77] *Regulation, supra* note 2, art. 23

execution or display of a short sale order of a "covered security" at a price that is less than or equal to the current national best bid.[78] On March 13, 2011, 54 securities listed on the New York Stock Exchange (NYSE) and the NYSE Amex triggered the circuit breaker, dragged by a significant fall in Japan's Nikkei Stock Average amid widespread worries about the impact of the 9.0 earthquake, the ensuing tsunami, and the nuclear power catastrophe. In particular, short selling was curbed in U.S.-listed shares of Hitachi, Cameco Corporation, Uranium Resources, and Uranium Energy Corporation.[79]

B. Foreseeable Lack of Coordination

At first glance, the Regulation seems to design an efficient supervisory framework that harmonizes and coordinates Members States' interventions.

Before implementing or renewing any measure required to face exceptional situations and before imposing any other measure required to confront a significant fall in price, any given competent authority (Primary Competent Authority) shall notify its E.U. counterparts and the ESMA.[80] This notification shall include details about the classes of instruments and transactions targeted by the measure as well as evidence supporting the implementation of such measure and its proposed effective date.[81] Upon receipt of such notification, each E.U. competent authority may decide to take any measure within its own jurisdiction it deems necessary to assist the Primary Competent Authority, in accordance with Articles 18 to 23 of the Regulation. E.U. capital markets being highly intertwined, this assistance is crucial to ensure the effectiveness of any measure contemplated by the Primary Competent Authority. However, one might worry (more on this in a moment) that other competent authorities will always succeed in finding a colorable

[78] Rule 201 of Regulation SHO defines "covered security" to mean any "NMS stock." Rule 600(b)(47) of Regulation NMS defines an "NMS stock" as "any NMS security other than an option." *See* 17 C.F.R. § 242.201(a)(1) (2012). Rule 600(b)(46) of Regulation NMS defines an "NMS security" as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." *See* 17 C.F.R. § 242.600(b)(46) (2012). The circuit breaker will therefore affect all securities, except options, traded on an exchange or over the counter.

[79] Kristina Peterson, *NYSE Sees Second Most Active Day of Short-Sale Curbs*, DOW JONES NEWSWIRES, Mar. 14, 2011.

[80] *Regulation*, *supra* note 2, art. 26.

[81] The notification shall be made no less than 24 hours before the intended effective date of the measure, unless exceptional situations make it impossible to give a 24-hour notice. *See Id.* art. 26(3).

argument as to the "necessity" to follow the Primary Competent Authority and intervene in their own jurisdiction, even in the absence of any exceptional situation or significant fall in price, bypassing the original impediments of Articles 18 to 23 of the Regulation.

The Regulation entrusts the ESMA with "a facilitation and coordination role" as to measures taken by E.U. competent authorities. Under Article 27(1) of the Regulation, the "ESMA shall ensure that a consistent approach is taken by competent authorities regarding measures taken under Section 1 [Powers of competent authorities] especially regarding when it is necessary to use powers of intervention under Section 1, the nature of any measures imposed and the commencement and duration of any measures."[82] In particular, after receiving notification of measures to be imposed or renewed because of an "exceptional situation,"[83] the ESMA shall issue an opinion, published on its website within 24 hours, on whether the measure or proposed measure is necessary to address the situation.[84] Specifically, the ESMA shall address whether the adverse events or developments constitute "a serious threat to financial stability or to market confidence in one or more Member States, whether the measure or proposed measure is appropriate and proportionate to address the threat, and whether the proposed duration of any such measure is justified."[85] However, the thrust of the ESMA's opinions is not far-reaching. Indeed, E.U. competent authorities shall only comply or explain:

> Where a competent authority proposes to take or takes measures contrary to an ESMA opinion under [Article 27(2)] or declines to take measures contrary to an ESMA opinion under that [article] it shall publish on its website within 24 hours of receiving the ESMA opinion a notice fully explaining its reasons for doing so.[86]

Therefore, the ESMA does not have the legal authority to prevent E.U. competent authorities from implementing, at their sole discretion, incoherent approaches throughout the European Union.

[82] *Id.* art. 27.

[83] There is no need for an opinion when measures are taken to face a significant decrease in price.

[84] *Regulation*, *supra* note 2, art. 27.

[85] *Id.*

[86] *Id.*

The Regulation is so prone to tilt the playing field against short sellers that it empowers the ESMA with its own powers of intervention. The ESMA can require enhanced disclosure of net short positions, prohibit or constrain short selling and prevent either natural or legal persons from entering into certain transactions relating to a financial instrument in two situations.[87] The first occurs when there is a threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the European Union with cross border implications. The second occurs when a competent authority or competent authorities have not taken measures to address the threat or measures that have been taken do not adequately address the threat. Before taking those measures, the ESMA shall consult, when appropriate, the European Systemic Risk Board and other relevant authorities.[88] According to Article 28(3) of the Regulation, the ESMA shall also take into account the extent to which the measure:

> (a) significantly addresses the threat to the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union or will significantly improve the ability of competent authorities to monitor the threat; (b) does not create a risk of regulatory arbitrage; (c) does not have a detrimental effect on the efficiency of financial markets, including by reducing liquidity in those markets or creating uncertainty for market participants, that is disproportionate to the benefits of the measure.[89]

This analysis reveals that the Regulation suggests requiring stricter constraints on the ESMA's intervention powers than on other E.U. competent authorities. This seems to be incoherent with the Regulation's primary objective (that is, designing a consistent and harmonized approach to short selling in the European Union).[90]

The Regulation gives legal authority to every E.U. competent authority to interfere with market mechanisms, without entrusting the ESMA with real harmonizing powers. Incoherent temporary restrictions on short selling might thrive, which is even more worrisome considering

[87] *Id.* art. 28.
[88] *Id.*
[89] *Id.*
[90] *Id.* art. 1.

the true impact of temporary restrictions on the functioning of capital markets.

C. Negative Consequences of Temporary Restrictions

Academic literature provides strong evidence that short selling is not responsible for market volatility or negative market moves and that short selling constraints are highly disruptive.

In December 2008, the SEC Office of Economic Analysis issued a memorandum to Christopher Cox, then-Chairman of the SEC, describing short selling activity during the first weeks of September 2008, just before the implementation of a short sale ban on financial stocks. The analysis suggests that during periods of extreme negative returns, "sell pressure is more intense for long trades indicating that short sales put less pressure on prices than other sales during periods of extreme negative returns."[91] This suggests that a significant decrease in price in periods of extreme negative returns might be a consequence of long investors' actions rather than short sellers' actions, which undermines the rationale for government intervention.

In their study of the 2008 naked short sales restrictions in the United States, Boulton and Braga-Alves show that short sale restrictions have a negative impact on liquidity as bid-ask spreads widen and trading volumes decrease.[92] Moreover, they find no evidence that these restrictions reduce volatility.[93] On the contrary, they find that volatility increases and conclude that market quality is affected during the restricted period.[94] What we should learn from this study is clear: short sales constraints have a detrimental effect on market efficiency.

Beber and Pagano also suggested that short selling restrictions are detrimental to liquidity ("especially for stocks with small market capitalization, high volatility and no listed options"), slow the price discovery process, and fail to support stock prices (except possibly for U.S. financial stocks).[95]

[91] Memorandum of the SEC Office of Economic Analysis, *Analysis of Short Selling Activity During the First Weeks of September 2008* (Dec. 16, 2008), *available at* http://www.sec.gov/comments/s7-08-09/s70809-369.pdf.

[92] Thomas J.Boulton & MarcusV. Braga-Alves, *The Skinny on the 2008 Naked Short Sale Restrictions*, 13 J. FIN. MARKETS 4, 5 (2010).

[93] *Id.*

[94] *Id.*

[95] Alessandro Beber & Marco Pagano, *Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis* (Aug. 2011) (unpublished working paper), *available at* http://ssrn.com/abstract=1502184.

As a consequence, E.U. competent authorities should restrain themselves and admit that restricting short selling actually aggravates the disorderly functioning of financial markets, even in the midst of a financial crisis.

V. CONCLUSION

The Regulation on Short Selling and Certain Aspects of Credit Default Swaps will implement reasonable rules applicable to naked short selling but will implement flawed transparency rules (specifically public disclosure of short sellers' identity and future implementation of a marking regime). More seriously, this Regulation entrusts competent authorities of Member States and the ESMA with far-reaching powers of intervention. As a consequence, incoherent approaches will interfere with market mechanisms, in particular with the price discovery process, undermining the European Union's competitiveness. The regulatory patchwork that emerged during the Crisis will materialize again in the future. As Tett observed,

> "[A]n age of bureaucrat hubris creates new risks. History is littered with examples where officials have tried to control financial flows and set prices, with disastrous results. It would be foolish to expect bureaucrats to be any less fallible today, given that finance is doubly complex and bureaucrats (like bankers) have warped incentives."[96]

There are no atheists in foxholes. And there are no libertarians in crises.

[96] Gillian Tett, *Beware a Hegelian Touch of Regulatory Hubris*, FIN. TIMES, Sept. 15, 2011.