

Commentary: Global Short Sale Regulation

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With markets melting up in recent months, the furor to enact short sale price tests has diminished. Nonetheless, the pressure to do something to quell public anxiety put the SEC's feet in motion, and some sort of further rule making is expected to occur any day now.

In case any reader has forgotten, the SEC's current proposal, released on April 10, 2009, is actually five different alternative proposals. First, the SEC proposed to restore the prior uptick rule, for many years the rule of the New York Stock Exchange, which would impose a short sale price test based on the last sale price (tick). Then, there is the modified uptick rule, the rule that formerly prevailed on NASDAQ, which would impose a short sale price test based on the last bid. Third, the "Circuit Breaker Halt Rule" would prohibit short sales after a stock's price had fallen by some prescribed percentage. The fourth proposal would impose the modified uptick rule after a circuit breaker was tripped, while under the fifth proposal, a circuit breaker's trip would impose the uptick rule.

It is possible that the SEC will choose one of these five alternatives and make that the new rule. I think it is more likely that the SEC will release a new proposal that will focus on one of the five alternatives, with some modifications.

One reason the SEC abandoned the prior short sale price tests is that they were frequently evaded by institutional investors placing short sale orders in Europe. The Frankfurt Stock Exchange, for example, listed every stock traded in NASDAQ for the purpose of accommodating orders that, among other things, would have run afoul of the NASDAQ's short sale rules if placed with a US broker-dealer. A US institution was not required to open an account in Frankfurt to place these orders. Instead, a US broker-dealer with an affiliate in Frankfurt could handle the order from a US account.

The current proposal would prohibit US broker-dealers from effecting trades outside the United States that would contravene the short sale rules. However, the SEC has no jurisdiction over non-US broker-dealers and cannot prevent a US institution from opening an account with a Frankfurt broker-dealer to evade US short sale rules. We can expect US broker-dealers to complain loudly if they are precluded from competing for this business.

Global regulators are well aware of the regulatory arbitrage problem inherent in inconsistent national regulations and have devoted much time in discussions at the G-20 summits seeking a solution. So far, these discussions have revolved around two concepts.

The most comprehensive solution for regulatory arbitrage is to appoint a single global regulator. However, this analog to one world government is exceedingly difficult to accomplish politically because it would require sovereign nations to surrender some of their governmental prerogatives. So, the second-best alternative, and the one most likely to result from the G-20 summits at this time, would be to establish a “college of regulators” where regulators from the G-20 nations would assemble to discuss issues of common concern.

Another solution that has been discussed at some length is to create parallel regulatory regimes. If every relevant nation adopted the same securities regulations, the economic incentive to engage in regulatory arbitrage would be removed. One reason to establish a college of regulators would be to achieve parallel regulatory regimes. So far, this effort has led to parallel proposals to establish a systemic regulator, bring hedge funds into similar regulatory regimes and institute similar regulations over certain derivative instruments, among other things.

The regulation of short sales, while widely recognized as an example of regulation that can be subverted through regulatory arbitrage, has not yet produced the consensus among regulators that is necessary to achieve parallel regulation.

On September 22, 2008, the Committee of European Securities Regulators (CESR), published a report describing the short sale regulations that have been adopted by members of the European Union and non-members in Europe who have agreed to subscribe to its market regulations. CESR functions as an advisory body to the European Commission, the primary law making and executive branch of the European Union. It is a college of regulators similar to the North American Securities Administrators Association (NASAA), and like NASAA, lacks any actual regulatory power of its own.

It turns out that only one European nation has adopted a short sale price test. Greece has adopted an uptick rule that applies to the short selling of shares listed on the Athens Stock Exchange. Greece is not a member of the G-20, but is indirectly represented by the European Union, which is a member.

As a practical matter, Greece lacks the facilities to handle US institutional orders in US stocks. So, their short sale regulations are more a matter of curiosity than importance. The same might be said for all but three of CESR’s 29 members. The

relevant jurisdictions for this purpose are the United Kingdom, France and Germany, all of which are members of the G-20 in their own right. I would argue that the first among these equals in the equity markets is the London Stock Exchange in the United Kingdom, although Frankfurt, Germany kicks up some dust now and again.

The Financial Services Authority (FSA) in the United Kingdom has specifically declined to adopt a price test for short sales. They think price tests fail to achieve their objectives and are, in some ways, harmful to the market. Instead, the FSA would impose disclosure obligations on short sellers. Anyone with a net short position greater than .25% of the outstanding shares for a security would be required to disclose this position to the regulators and the public. The FSA's short-sale regulation through disclosure regime has been adopted in some form by seven other members of the European Union. The SEC declined to extend its disclosure regime, which for a brief time required short sale reports by investment managers that manage aggregate positions composed of more than \$100 million of securities.

Germany, on the other hand, has adopted temporary rules to prohibit "naked short sales" of the stocks of eleven financial institutions. These rules do not extend to other stocks traded in Germany. Rules more or less prohibiting naked short sales have been adopted in the United States and ten of CESR's members, including Germany.

France imposed a temporary prohibition on short sales in stocks issued by financial institutions, which was recently extended to January 2010. Similar prohibitions were imposed in the United States, United Kingdom, Denmark, Iceland, Ireland, Italy, The Netherlands and Norway. Short sales in all equities have been temporarily or permanently prohibited in three other European nations.

To sum it up, none of the big three European trading markets has adopted, or proposed to adopt, the short sale price tests proposed by the SEC. Moreover, each of them takes a different approach to short sale regulation, none of which is comparable in any meaningful way to US regulation.

It is true that it is much more expensive to trade on European exchanges, primarily as a result of the high cost of clearing European transactions. That fact of life will limit the economic advantage from regulatory arbitrage. Nonetheless, without a consensus on short sale regulation among regulators of globally-recognized stock exchanges, the SEC's proposed price tests will be subverted in much the same way they were when abandoned in 2007. The opportunities to profit from these trades, at the expense of US broker-dealers, may very well result in greater efficiencies in European clearing and settlement operations as European securities firms seek to take advantage of their more permissive regulatory environment.

It gets worse. Since it is relatively easy in this age of global communications to send orders to non-US broker-dealers, the SEC's proposed short sale price tests will necessarily exert the greatest impact on those who are least able to avoid them. It is not feasible for retail investors and smaller institutions to open brokerage accounts in non-US jurisdictions. So, it is the smaller investors and the broker-dealers who accept their orders who will bear the primary regulatory burden of the SEC's proposed price tests.

I submit that no one would propose a regulation on short sales that was directly targeted at the behavior of smaller investors. The proposed regulations are based on the vain hope that larger institutions can be brought within their grasp.

None of the five proposed alternatives have been adopted yet. We can only hope that this genie remains in the bottle.

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