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VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

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WORKING DOCUMENT OF THE COMMISSION SERVICES (DG INTERNAL MARKET) CONSULTATION PAPER ON HEDGE FUNDS

AZ ZKA:InvG

AZ BVR: EG-INV-RE

Dear Mr. Bohan,


Please find enclosed our comments on the working document of the commission services regarding the consultation paper on hedge funds. We are grateful for the opportunity to comment on this important issue which has given rise to some controversy over the last couple of month.

Yours sincerely,

on behalf of the Zentraler Kreditausschuss

Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V. BVR/
National Association of German Cooperative Banks

by proxy 
Dr. Klaus Möller

by proxy 
Dr. Diedrich Lange

Enclosure

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Response on the

PUBLIC CONSULTATION OF THE EUROPEAN COMMISSION ON HEDGE FONDS

January 2009

Preface

The Zentraler Kreditausschuss¹ appreciates the enquiry of the European Commission concerning the need for action in case of regulating the activities of hedge funds as is demanded also by the European Parliament², and it shares the opinion that more transparency and supervision are necessary in this field. Since the G8 summit in Heiligendamm in the summer of 2007 some considerable progress has been achieved concerning the question of transparency of hedge funds. Priority was given to the formulation of binding “Codes of Conduct“ by means of the codes of the Hedge Fund Working Group (HFWG) and the President’s Working Group (PWG) that were presented in early 2008. But besides the hedge fund business itself, also state-run and international organizations are working on the setting of standards for hedge funds. Here, the Financial Stability Forum (FSF) is particularly noteworthy. In May 2007 – on the occasion of the G7-summit - the FSF published a continuation of the “Report on Highly Leveraged Institutions“ of the year 2000. Already in October a report followed which informed about the progresses concerning the implementation of the recommendation given in it. The FSF placed the responsibility for the reduction of the systematic risk of hedge funds with the prudential authorities as well as with the market participants. The FSF demanded a strengthening of the market discipline to reduce the systemic risks connected to the hedge funds.

In the meantime, the spreading of the international financial crisis made it clear, though, that transparency is not only an important requirement for the business model of hedge funds but that it is fundamental for a functioning financial market. Therefore, the regulation of hedge funds has to be seen within the broader context of the global financial system that is to be newly created. A global financial system that is orientated towards market economy principles should give priority to approaches of self regulation also in the future wherever they are promising as long as they are not without obligation. They can only fulfil their task if the setting up of standards is accompanied by the obligation to keep and to control them.

This new structuring of the supervisory legislation for hedge funds should be separated from the examination of short selling as this is not a specific characteristic of hedge funds but a general method in trading. It is currently being examined by the prudential authorities IOSCO and CESR. The ZKA commented on these consultations. The answers are enclosed as **Annexes 1**

1 The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for the mortgage banks. Collectively, they represent more than 2,200 banks.

2 European Parliament decision of 23 September 2008, with recommendations for the Commission to Hedge Funds and Private Equity (2007/2238(INI)), annex to the decision, recommendation 5.

and 2 to this letter for the information of the reader. In short, in our view short selling is of no systemic importance for a market failure. It therefore does not demand any particular regulation.

The Commission paper discusses market integrity aspects entirely with regard to price fluctuations and the impact of short selling. It should be added that here are other types of potential impact on market integrity that have to be regarded. Hedge funds are characterized by strong financial manager incentivizing (performance fees are, as a rule, the most important part of the revenues generated by hedge funds; they are a significant component of the direct, personal compensation of hedge fund managers). If this combines with a low level of conduct of business and governance standards (as is the case in some jurisdictions), an increased risk of market abuse and fraudulent action is the consequence.

As to the questions:

(1) Are the above considerations sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

There is no internationally accepted definition of what hedge funds are. This is mainly due to the fact that the term “hedge fund“ combines a variety of different institutions with very diverging business models and market activities. As they do not form a homogeneous group like e.g. investment funds do, which are subject to a strict regulation including extensive investment requirements, it is hardly conceivable to find a regulation approach that can do justice to the heterogeneity of the hedge funds business. Any measure of the European Union, be it what it may, has to be aware of the difficulty to even define the term “hedge fund“; a simplifying attempt to define it brings with it the risk that the institutes to be covered by such a definition will, as a reaction to this attempt to cover them by supervisory legislature, simply transform themselves with the aim of supervisory arbitrage.

(2) Given the international dimension of hedge fund activity, will a purely European response be effective?

A European regulation of hedge funds is not sufficient but has to be complemented by a global transparency regime and by supervision. The guarantee of the financial stability requires an international coordination on politics due to the global activity of the hedge funds and the fact that they are scarcely regulated on the major markets. The improved transparency of hedge funds is generally regarded as a suitable means to increase financial stability. Given the complex relations and diverging interests, quick results cannot be expected. Any success can only be reached on the basis of an international agreement by means of which a binding character of the self commitment in the form of a Code of Conduct could be reached, the compliance being enforced accordingly by state monitoring and transparency obligations. In addition to this, any violations against the Code of Conduct should be published. Moreover, also our proposal, detailed below, may be successful to make the UCITS label an attractive brand for umbrella hedge funds which, if it becomes a success, can have a standard setting effect.

The acceptance and effectiveness of the Code of Conduct require the inclusion of offshore locations. In this field, the negotiation potential of the EU with respect to the market access has to be tapped. This applies in particular with respect to the current considerations of the European Commission to introduce a private placement regime for the Single European Market which is supposed to refer to funds and among them also to those from third countries.³

An international working group should be founded to gather the data that have already been collected on the national level and that are suitable for the assessment of the systemic risks potentially arising from hedge funds. From a German perspective, the already existing reports of major loans would be appropriate. In Germany, credit institutions regularly have to hand in to the prudential authorities reports about their granting of loans. These reports include exposures of hedge funds.

This working group should examine the possibilities of an international harmonization of these collections of data. To achieve the acceptance of the respective market participants, such a project must not lead to a tightening of the supervisory and reporting obligations for the globally active banks, though. Moreover, it should always be examined by means of an impact assess-

³ See the respective demand of the European Parliament in the „European Parliament Resolution of 13 December 2007 on Asset Management II (2007/2200 (INI))“, § 5.

ment whether additional data are actually able to improve market discipline in a sustainable way. What would be sensible and easily implementable is a regular exchange of information between the prudential authorities. The national prudential authorities of the G7 countries should intensify or start the dialogue with the hedge funds and the hedge fund managers within their area of supervision for this purpose and they should include their findings in a regular exchange of experiences of the prudential authorities.

(3) Does recent experience require a reassessment of the systemic relevance of hedge funds?

No, this has been known at least since the LTCM case of 1998. There is no doubt that a systemic relevance of hedge funds does exist. But the adjustment process within the hedge funds business that started already in 2008 suggests that the systemic risk arising from hedge funds can be assessed also in the future as being relatively small. This assessment is generally being shared by the market participants and the prudential authorities.

Nevertheless, the fact is causing concerns that the risks for market liquidity that arise indirectly from hedge funds are difficult to assess. Moreover, there are loss risks for investors, prime brokers, and banks. Against this background it is no surprise that, as time passed by, the discussions about transparency and regulation of hedge funds moved away from questions of systemic risk towards questions of investor protection and market integrity. Of course, it will still be necessary to keep an eye on the potential systemic risks of hedge funds. The instruments that have been developed for this purpose have had no opportunity yet to stand the test, though. Therefore it is recommended to help the FSF proposals becoming internationally effective and to convince the hedge funds business that it agrees on a uniform "Code of Conduct" the compliance of which will be supervised and any breaches of which will be punished by the principle of "name and shame". By the way, a comparable position can be found also in the final communiqué of the G20 summit of 15 November 2008, in Washington.

(4) Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?

Yes, alternative approaches are necessary. See our answer to question 2 + 3.

(5) Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?

The discussion about a greater transparency of hedge funds since the G8 summit of Heiligendamm has made it clear that this form of regulation is not sufficient. Under the leadership of the Financial Stability Forum (FSF) therefore additional measures for achieving greater transparency have been presented. In May 2007 – on the occasion of the G7-summit - the FSF published a continuation of the “Report on Highly Leveraged Institutions“ of the year 2000. Already in October a report followed which informed about the progresses concerning the implementation of the recommendation given in it.

In its paper of May 2007, the FSF placed the responsibility for the reduction of the systemic risk of hedge funds with the prudential authorities as well as with the market participants. The FSF demanded a strengthening of the market discipline to reduce the systemic risks connected to hedge funds. This target was supposed to be reached by the following measures:

- The prudential authorities are supposed to
 - persuade prime brokers to improve their risk management with respect to hedge funds;
 - cooperate with the prime brokers to improve their robustness against a possible erosion of market liquidity;
 - examine whether improved data about the consolidated position of the prime brokers with respect to hedge funds could facilitate the tasks of the prudential authorities.

- Prime Broker and investors are supposed to
 - take measures for the improvement of market discipline and
 - demand suitable and timely information from hedge funds about the risk and the value of the portfolio.

- The hedge funds are supposed to come up with a “Code of Conduct” given the public expectation for better standards.

In October 2007, the FSF was able to report that the prudential authorities have committed themselves to the task of getting an overview about the risks of the major market participants with respect to hedge funds and of examining the practice of risk management.

The financial crises that began in the summer of 2007 was an additional challenge for the risk management of prime brokers. The conclusions the prudential authorities drew from it also were included into the “FSF Working Group on Market and Institutional Resilience” and should be transferred also to other market participants who work with a leverage similar to hedge funds.⁴

The FSF also reports that the international prudential authorities examine on staff level which quantitative and qualitative data – collected by prime brokers and banks in a consistent manner – would allow a better overview over the positions of hedge funds.

Finally, the FSF stressed that a better market discipline would require that prime brokers and investors receive reliable information from the hedge funds. In this context the FSF appreciated the initiatives of the Hedge Fund Working Group and of the President’s Working Group for the setting up of a “Code of Conduct” for the behaviour of hedge funds managers. And it stressed that it would appreciate regular reports from the trade about the implementation of standards and their effects with respect to greater transparency and better risk management.

The task of the upcoming international conferences therefore should be to help the proposals of the FSF achieve international effectiveness. Additional regulating measures are not regarded as necessary.

(6) Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? Has it led to better/worse price formation and trading conditions?

As to this, there is no empiric data at hand.

(7) Are there situations where short-selling can lead to distorted price signals and where restrictions on short-selling might be warranted?

⁴ “Recent events have demonstrated the importance of disciplined management of counterparty credit exposures. Existing national supervisory guidance on counterparty exposures to hedge funds needs to be extended to exposures to other large, highly leveraged counterparties, including other financial institutions and financial guarantors.”
FSF, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, April 2008.

(8) Are there circumstances in which short-selling can threaten the integrity or stability of financial markets? In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?

The key argument in favour of short selling is its contribution to the **efficient functioning of the financial markets**. This positive impact is largely undisputed and has been widely confirmed by a number of academic studies⁵. Although their findings are based on research undertaken before the financial crisis, we still consider them to be fundamentally valid. The ability to sell short enhances information efficiency so that information about the affected company is reflected more rapidly in the price of its shares. Short sales can thus help to correct excessive price increases and the formation of bubbles. They also play a role in facilitating market liquidity since the associated sell and buy transactions increase supply and demand respectively. The basic argument of greater market efficiency applies not only to covered but also to naked short sales, thus raising the question of whether a ban can be justified. In our view, this is extremely doubtful.

We would like to point out that naked short sales do not cover transactions on futures and options exchanges (especially short futures). This is also the view of the German financial regulator BaFin. But where naked short selling is concerned, it is argued that the lack of cover theoretically enables sellers to sell more shares than are actually in circulation and use the high volume of sales to push down the price of the affected stock. The temporary restrictions on short selling introduced in response to the financial crisis were intended to prevent this and help to stabilise the markets. Initial academic studies on the impact of these measures suggest, however, that the adverse influence of short selling was strongly overestimated and that the ban has consequently failed to have the desired stabilising effect⁶. There is no evidence that the prices of affected shares behaved substantially differently before and after the introduction of the ban or behaved differently from shares which were not affected by the restrictions. These findings offer no basis for a long-term ban on either covered or uncovered short selling since

⁵ See for example:

Bris, A./ Goetzmann, W./ Zhu, N. (2007): Efficiency and the Bear: Short Sales and Markets Around the World, *The Journal of Finance*, Vol. 62, Issue 3, pp. 1029-1079.

Charoenrook, A./ Daouk, H. (2005): A Study of Market-Wide Short-Selling Restrictions, working paper, Vanderbilt University und Cornell University.

Saffi, P./ Sigurdsson, K. (2007): Price Efficiency and Short Selling, AFA 2008 New Orleans Meetings Paper.

⁶ For an analysis of six different markets, including UK, USA and Germany, see:

Marsh, I. W./ Niemer, N. (2008): The Impact of Short Sales Restrictions.

For an analysis focusing on the US-market see:

Bris, A. (2008): Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order.

Bris, A. (2008): Shorting Financial Stocks Should Resume, *The Wall Street Journal*, 29 September.

measures of this kind do not seem capable of reducing volatility or significantly slowing a decline in prices. The studies show that, in the US, intraday volatility and bid-ask spreads have actually increased, thus making the overall market situation even worse. The fact that short selling plays a role in certain types of market abuse (e.g. short and distort) is no justification for banning the practice either. Short sales are simply used as a tool in such cases and are not damaging per se. Statutory arrangements are already in place to combat abusive behaviour. Systematic manipulation of a share price, together with the dissemination of misleading information which may accompany it, is illegal and punishable as market abuse.

Another argument against an outright ban on naked short selling is the experience of the German market, which in any event has had no problems with this practice to date. Even the temporary ban on the naked short sales of certain financial instruments is described by BaFin as merely a "preventative" measure. The reason why naked short selling does not play a greater role in Germany lies essentially in the rules governing the clearing and settlement of securities. First, Germany has an extremely short maximum settlement period of t+2 and, second, market participants face sanctions by the CCP or their counterparty if this period is exceeded (CCP close-out requirements or the purchase of the securities by the counterparty at the expense of the short seller).

For this reason, naked short sales are limited in Germany to a relatively short, two-day window, in which sellers have to acquire shares to cover their position if they are to avoid sanctions. We believe that the international introduction of appropriate and short maximum settlement periods, coupled with the enforcement of penalties in the event of their being exceeded (close-out requirements or the purchase of securities by the counterparty at the short-seller's expense), would be more effective than an outright ban on short selling.

(9) How should the internal processes of hedge funds be improved, particularly with respect to risk management? How should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?

Risk management, the assessment of illiquid assets, and the avoidance of conflicts of interest are of utmost importance for the stability of the finance system. An according approach for the hedge funds business can be deduced from a binding implementation of a uniform and supervised Code of Conduct. The existing handbooks of the Hedge Fund Working Group and the President's Working Group provide an excellent basis for an improvement of the risk management, an improvement of the methods for the assessment of illiquid assets and of processes for the avoidance of conflicts of interests. The negotiations for the global financial system should therefore be used to achieve such a uniform Code of Conduct.

An inclusion of hedge funds – differentiated into umbrella hedge funds and single hedge funds – into the UCITS regime (possibly marked in a special way, e.g. the alternative UCITS) have been discussed by the European Commission and also by the European Parliament for a considerable period of time. In some member states like Germany hedge funds are already regulated in one way or another within the framework of investment law regulations which is along the lines of UCITS legislation. The assignment of the UCITS label to hedge funds that meet the respective quality standards concerning organization, management, customer information, and treatment of conflicts of interests is a suitable market economy regulatory instrument for the desired standardization and transparency. This incentive can only have an optimal effect on hedge funds from third countries if a private placement regime as it has been planned for a considerable period of time by the European Commission renounces to include hedge funds from third countries. Finally, a retail distribution of single hedge funds under the UCITS should be forbidden also in the future (which is the current legal situation in Germany).

(10) Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?

It is correct to make, from a protection view, a distinction between retail and professional investors. In the case of placement with institutional and other professional clients, much can be left to market-led practices and standards, like for example the global investment performance standards (GIPS). Also in this case, however, governance and conduct of business standards of fund managers have to be appropriate in order to mitigate market integrity and reputational risk. Investors in hedge funds currently are exclusively institutional investors and very wealthy private persons. Both groups are able to demand from hedge funds all the information they need for an informed investment decision. A survey among hedge funds investors carried out by PriceWaterhouseCoopers in January 2008 proves that this information is of equal importance for the transparency of a hedge fund. This study also shows, though, that hedge funds do not in all areas fulfil the expectation of the investors concerning the provision of information. In case of insufficient information, though, every investor has the possibility to dispense with or terminate an investment. If this does not happen, this is the responsibility of the investor.

Nevertheless, there is room for improvements concerning this question. Provisions concerning the information of investors are included in the already mentioned Code of Conduct in detailed

form. Therefore, it should improve the flow of information of hedge funds to their investors if these Codes of Conducts are helped to achieve unrestricted acceptance and effectiveness.

The measures suggested in the answer to question 2 and the inclusion of an alternative UCITS regime, as mentioned under question 9, could set minimum standards for the transparency of investment policies and thus influence the market.

(11) In light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?

On the European level it has been discussed for a long time whether umbrella hedge funds should be included in the European investment guideline (Directive on UCITS). We would support such a step because it would give reason to define hedge funds at least for the European Single Market and at the same time it would create the possibility of a diversification of portfolios. As to sales, investors would be always protected by the MiFID so it would be guaranteed that no private investor will take a risk that he individually cannot bear (which is the current legal situation in Germany).

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Comments of the Zentraler Kreditausschuss¹ on the questions of the IOSCO Short Selling Task Force regarding future regulatory approaches to short selling

30 December 2008

¹ The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.

The ZKA thanks the IOSCO Short Selling Task Force for the opportunity to put forth our views on future principles for the regulation of short selling. We welcome the task force's work on establishing a common international approach to this matter and fully agree that adverse implications for the efficient functioning of the markets need to be minimised. Extensively integrated financial markets require an internationally consistent regulatory framework. Many financial institutions operate across a multiplicity of different countries and monitoring differing rules in many jurisdictions is complicated and highly inefficient.

(1) What short selling activities should be permissible?

The key argument in favour of short selling is its contribution to the **efficient functioning of the financial markets**. This positive impact is largely undisputed and has been widely confirmed by a number of academic studies². Although their findings are based on research undertaken before the financial crisis, we still consider them to be fundamentally valid. The ability to sell short enhances information efficiency so that information about the affected company is reflected more rapidly in the price of its shares. Short sales can thus help to correct excessive price increases and the formation of bubbles. They also play a role in facilitating market liquidity since the associated sell and buy transactions increase supply and demand respectively.

The basic argument of greater market efficiency applies not only to covered but also to naked short sales, thus raising the question of whether a ban can be justified. In our view, this is extremely doubtful.

We would like to point out that naked short sales do not cover transactions on futures and options exchanges (especially short futures). This is also the view of the German financial regulator BaFin. But where naked short selling is concerned, it is argued that the lack of cover theoretically enables sellers to sell more shares than are actually in circulation and use the high volume of sales to push down the price of the affected stock. The temporary restrictions on short selling introduced in response to the financial crisis were intended to prevent this and help to stabilise the markets. Initial academic studies on the impact of these measures suggest, however, that the adverse influence of short selling was strongly overestimated and that the

² See for example:
Bris, A./ Goetzmann, W./ Zhu, N. (2007): Efficiency and the Bear: Short Sales and Markets Around the World, *The Journal of Finance*, Vol. 62, Issue 3, pp. 1029 - 1079.
Charoenrook, A./ Daouk, H. (2005): A Study of Market-Wide Short-Selling Restrictions, working paper, Vanderbilt University und Cornell University.
Saffi, P./ Sigurdsson, K. (2007): Price Efficiency and Short Selling, AFA 2008 New Orleans Meetings Paper.

ban has consequently failed to have the desired stabilising effect³. There is no evidence that the prices of affected shares behaved substantially differently before and after the introduction of the ban or behaved differently from shares which were not affected by the restrictions. These findings offer no basis for a long-term ban on either covered or uncovered short selling since measures of this kind do not seem capable of reducing volatility or significantly slowing a decline in prices. The studies show that, in the US, intraday volatility and bid-ask spreads have actually increased, thus making the overall market situation even worse.

The fact that short selling plays a role in certain types of market abuse (e.g. short and distort) is no justification for banning the practice either. Short sales are simply used as a tool in such cases and are not damaging per se. Statutory arrangements are already in place to combat abusive behaviour. Systematic manipulation of a share price, together with the dissemination of misleading information which may accompany it, is illegal and punishable as market abuse.

(2) The appropriate controls to regulate permissible short selling

Another argument against an outright ban on naked short selling is the experience of the German market, which in any event has had no problems with this practice to date. Even the temporary ban on the naked short sales of certain financial instruments is described by BaFin as merely a “preventative” measure. The reason why naked short selling does not play a greater role in Germany lies essentially in the **rules governing the clearing and settlement of securities**. First, Germany has an extremely short maximum settlement period of t+2 and, second, market participants face sanctions by the CCP or their counterparty if this period is exceeded (CCP close-out requirements or the purchase of the securities by the counterparty at the expense of the short seller).

For this reason, naked short sales are limited in Germany to a relatively short, two-day window, in which sellers have to acquire shares to cover their position if they are to avoid sanctions. We believe that the international introduction of appropriate and short maximum settlement periods, coupled with the enforcement of penalties in the event of their being exceeded (close-out requirements or the purchase of securities by the counterparty at the short-seller’s expense), would be more effective than an outright ban on short selling.

³ For an analysis of six different markets, including UK, USA and Germany, see: Marsh, I. W./ Niemer, N. (2008): The Impact of Short Sales Restrictions.
For an analysis focusing on the US-market see:
Bris, A. (2008): Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order.
Bris, A. (2008): Shorting Financial Stocks Should Resume, The Wall Street Journal, 29 September.

Pre-borrowing requirements would be tantamount to a ban on short sales. We do not agree with such a step for the reasons explained above.

See our reply to point 3 below for our comments on **disclosure and reporting**.

The US had a **tick rule**⁴, which was introduced in 1938 and withdrawn in 2007. The decision to drop the rule was taken in light of the findings of a pilot study, which showed that the tick rule was not necessary to prevent market manipulation and, in addition, had a slightly adverse effect on liquidity. For these reasons, we do not believe it would be useful to introduce such a restriction on short selling.

(3) Disclosure and reporting of short sales

As a general point, it is important in any discussion of this issue to make a distinction between reporting short sales to the competent authorities and disclosure to the market.

The more detailed and prompt the disclosure of short sales to other market participants, the more likely it is that such a disclosure will have an adverse effect. First, there is a risk of a cornering of short sellers at the time of repurchase and, second, the short sales may be seen as an indication of falling prices, thus putting unnecessary pressure on the security. For these reasons, we reject the introduction of a requirement to disclose either naked or covered shorts to the market. But we also have reservations about a requirement to report short sales to supervisors since the resulting administrative burden would not be matched by any discernible benefit. The introduction of such a requirement would therefore be disproportionate, especially if intermediaries rather than the short sellers themselves were affected.

Although we fundamentally reject the idea of reporting requirements, our comments on their possible form – should they nevertheless be introduced – are as follows:

The question of who will do the reporting is key to the issue of proportionality. Reports by intermediaries could only be based on the information available to them. Responsibility for supplying an overview of a particular investor's total holdings can therefore only lie with the investor himself. Since intermediaries normally only have full information about the securities they themselves hold, they have no way of ascertaining whether their clients may have holdings of the security in question in another external account and thus whether a transaction

⁴ Under the US tick rule, a short sale was only permitted if the last price of the security was higher than the last price but one or if the last price remained the same but was higher than the last different price.

really constitutes a short sale or not. Reports by intermediaries may therefore paint a false picture.

(i) What to report and level of detail?

We would like to reiterate that we are fundamentally opposed to reporting requirements of any kind. If reporting requirements are nevertheless introduced, these should be limited to shares. The inclusion of listed derivatives would be particularly problematic because state interference of this kind could cause major disruption in the derivatives markets.

(ii) The trigger level of reporting?

We do not believe that a specific reporting threshold would be helpful because it would offer potential for circumventing requirements, especially for the purposes of market abuse.

(iii) What constituents to report?

No specific comments.

(iv) Report to whom?

If a reporting system is introduced, the information should be reported using channels which already exist in member states. In Germany, reports are submitted direct to the competent authorities.

(v) Frequency of regulatory reporting?

It would make good sense for reports to the competent authorities to be submitted promptly.

(vi) What information for public disclosure and how to disseminate and frequency of disclosure?

Should information have to be disclosed to the market, it is essential for such disclosure to take place only after a time-lag and in consolidated form. The disclosure of individual transactions would have undesirable consequences due to the potential response of other market participants. First, there would be a risk of a cornering of short sellers at the time of repurchase and, second, the short sales might be seen as an indication of falling prices, thus putting unnecessary pressure on the security.

(4) What activities should be exempted from restrictions?


There should be exemptions for

- open transactions subject to the designation of the counterparty
(*Aufgabegeschäfte*)
- market making transactions
- sales triggered by fixed-price transactions on behalf of clients
- short sales by issuers necessitated for hedging purposes
- special features of transactions in convertible/exchangeable bonds.


Yours sincerely

on behalf of the Zentraler Kreditausschuss,

Bundesverband deutscher Banken



(Georg Baur)



(Felix Koehn)

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Mr. Carlo Comporti
Mr. Michael Treip
Committee of European
Securities Regulators (CESR)
11-13 Avenue de Friedland
75008 PARIS
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CESR's Call for Evidence "Regulation of Short Selling by CESR Members"
here: Comments of the Zentraler Kreditausschuss (ZKA)

Dear Mr. Comporti, dear Mr. Treip,

Please find enclosed our comments on the CESR Call for Evidence regarding the regulation of short selling. We are grateful for the opportunity to comment on this important issue which has given rise to some controversy over the last couple of months.

Yours sincerely,
for the Zentraler Kreditausschuss
Bundesverband deutscher Banken



Georg Baur



Felix Koehn

Enclosure

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**Comments of the
Zentraler Kreditausschuss¹
on CESR's Call for Evidence
"Regulation of Short Selling by CESR Members"**

Ref.: CESR/ 08-1010

20 January 2009

¹ The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.

We appreciate the opportunity to comment on the call for evidence tabled by the Committee of European Securities Regulators (CESR) concerning future principles for the regulation of short selling. We welcome the efforts of the CESR task force to facilitate convergence of the measures to be taken by national regulators. The goal should be to establish a common European approach to the regulation of short sales while minimising the adverse implications for the efficient functioning of the markets. We consider this objective extremely important since the extensively integrated European financial markets require a consistent regulatory framework. Many financial institutions operate across a multiplicity of different countries and monitoring differing rules in many jurisdictions is complicated and highly inefficient.

Benefits of short selling and permissible activities

Contribution to the efficiency of the financial markets

The key argument in favour of short selling is its contribution to the efficient functioning of the financial markets. This positive impact is largely undisputed and has been widely confirmed by a number of academic studies². Although their findings are based on research undertaken before the financial crisis, we still consider them to be fundamentally valid. The ability to sell short enhances information efficiency so that information about the affected company is reflected more rapidly in the price of its shares. Short sales can thus help to correct excessive price increases and the formation of bubbles. They also play a role in facilitating market liquidity since the associated sell and buy transactions increase supply and demand respectively. This basic argument of greater market efficiency applies to covered as well as to naked short sales.

Risk management

Another major benefit of short selling is its contribution to efficient risk management. In recent years especially, futures and options products have proved to be valuable instruments offering extensive, scalable protection against downside risks. The providers of these products rely on short sales to a certain extent to hedge their own positions. Any restrictions or bans on short selling would therefore increase the cost of risk management for financial and non-financial firms.

² See for example:
Bris, A./ Goetzmann, W./ Zhu, N. (2007): Efficiency and the Bear: Short Sales and Markets Around the World, *The Journal of Finance*, Vol. 62, Issue 3, pp. 1029 - 1079.
Charoenrook, A./ Daouk, H. (2005): A Study of Market-Wide Short-Selling Restrictions, working paper, Vanderbilt University und Cornell University.
Saffi, P./ Sigurdsson, K. (2007): Price Efficiency and Short Selling, AFA 2008 New Orleans Meetings Paper.

Share placements

The ability to sell short is also beneficial to certain types of share placements. Take, for example, recapitalisations by German listed joint stock companies through rights issues, which can usually be traded on an exchange. Shareholders can sell their subscription rights or buy additional rights. Normally, one of the underwriting banks (the so-called coordinator of the rights trading) will set prices during the subscription period because subscription rights usually trade at very low volumes and so prices can otherwise become highly volatile. This practice is intended to ensure that rights trading takes place in an orderly manner. If the underwriting bank buys subscription rights during this price-making process, it will usually sell some existing shares to hedge against building up an excessively large position of its own in these shares (and/or subscription rights). The hedging mechanism can also take the form of a short sale. This is the only way for issuing banks to support the rights trading in an economically viable manner. Rights trading makes an important contribution to the success of a rights issue and consequently plays a major role in raising equity capital, especially in economically difficult situations.

Convertible or exchangeable bonds

Short sales play a key role, too, in the trading of convertible or exchangeable bonds. Hedge funds, for example, normally use short sales to hedge the risk of a fall in the value of the shares underlying a convertible bond. For investors of this kind, the ability to sell short is sometimes even a prerequisite for acquiring convertible bonds. Hedge funds, in their capacity as investors, have become increasingly important in recent years to the marketability of equity-linked products. It is therefore also in the interests of issuers to take account of their needs.

Naked short sales

The benefits of short selling outlined above are considerable and the drawbacks associated with a general ban would clearly not be acceptable. The question then arises as to whether a ban on naked short sales would be justifiable. In our view, this is extremely doubtful since the basic argument of greater market efficiency, in particular, applies not only to covered but also to naked short sales.

We would like to point out in this context that naked short sales do not cover transactions on futures and options exchanges (especially short futures). This is also the view of the German financial regulator BaFin. But where true naked short selling is concerned, it is argued that the lack of cover theoretically enables sellers to sell more shares than are actually in circulation and use the high volume of sales to push down the price of the affected stock. The temporary restrictions on short selling introduced in response to the financial crisis were intended to

prevent this and help to stabilise the markets. Initial academic studies on the impact of these measures suggest, however, that the adverse influence of short selling was strongly overestimated and that the ban has consequently failed to have the desired stabilising effect³. There is no evidence that the prices of affected shares behaved substantially differently before and after the introduction of the ban or behaved differently from shares which were not affected by the restrictions. These findings offer no basis for a long-term ban on either covered or uncovered short selling since measures of this kind do not seem capable of reducing volatility or significantly slowing a decline in prices. The studies show that, in the US, intraday volatility and bid-ask spreads have actually increased, thus making the overall market situation even worse.

Market abuse

The fact that short selling plays a role in certain types of market abuse (e.g. short and distort) is no justification for banning the practice either. Short sales are simply used as a tool in such cases and are not damaging per se. Statutory arrangements are already in place to combat abusive behaviour. Systematic manipulation of a share price, together with the dissemination of misleading information which may accompany it, is illegal and punishable as market abuse.

Exemptions

In conclusion, we would like to reiterate that, for the reasons mentioned above, we see no legitimate reason for a ban on short selling. This includes naked short selling. If, however, restrictions of any kind are to be introduced, it needs to be ensured that there are exemptions for certain concrete activities that are of great importance to the efficient functioning of the financial markets and that rely on short selling for effective execution. These are:

- open transactions subject to the designation of the counterparty (*Aufgabegeschäfte*),
- market making transactions,
- sales triggered by fixed-price transactions on behalf of clients,
- short sales by issuers necessitated for hedging purposes,
- special features of transactions in convertible/exchangeable bonds.

³ For an analysis of six different markets, including UK, USA and Germany, see: Marsh, I. W./ Niemer, N. (2008): The Impact of Short Sales Restrictions.
For an analysis focusing on the US-market see:
Bris, A. (2008): Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order.
Bris, A. (2008): Shorting Financial Stocks Should Resume, The Wall Street Journal, 29 September.

Appropriate controls to regulate permissible short selling

Clearing and settlement rules

Another argument against an outright ban on naked short selling is the experience of the German market, which in any event has had no problems with this practice to date. Even the temporary ban on the naked short sales of certain financial instruments is described by BaFin as merely a “preventative” measure. The reason why naked short selling does not play a greater role in Germany lies essentially in the rules governing the clearing and settlement of securities. First, Germany has an extremely short maximum settlement period of t+2 and, second, market participants face sanctions by the CCP or their counterparty if this period is exceeded (CCP close-out requirements or the purchase of the securities by the counterparty at the expense of the short seller).

For this reason, naked short sales are limited in Germany to a relatively short, two-day window, in which sellers have to acquire shares to cover their position if they are to avoid sanctions. We believe that the international introduction of appropriate and short maximum settlement periods, coupled with the enforcement of penalties in the event of their being exceeded (close-out requirements or the purchase of securities by the counterparty at the short-seller’s expense), would be more effective than an outright ban on short selling.

Pre-borrowing requirements

Pre-borrowing requirements would be tantamount to a ban on naked short sales. We do not agree with such a step for the reasons explained above.

Tick rule

The US had a tick rule⁴, which was introduced in 1938 and withdrawn in 2007. The decision to drop the rule was taken in light of the findings of a pilot study, which showed that the tick rule was not necessary to prevent market manipulation and, in addition, had a slightly adverse effect on liquidity. For these reasons, we do not believe it would be useful to introduce such a restriction on short selling.

Restricting short selling during rights issues

In 2008, short selling came under the spotlight in the UK in connection with falling prices during rights issues. Several banks saw their share price drop considerably while trying to raise new capital. This called into question – at least temporarily – the ability for their issues to be

⁴ Under the US tick rule, a short sale was only permitted if the last price of the security was higher than the last price but one or if the last price remained the same but was higher than the last different price.

placed. The November 2008 report by the Rights Issue Review Group⁵, however, found that short selling was at most one of several reasons for the difficulties experienced. Among the main reasons identified by the report were a generally difficult market environment for share issues (especially in the banking sector) and, above all, the lengthy 21-day subscription period, which is much longer than that in Germany. With respect to short selling, the review group pointed out that the FSA was planning consultations in 2009. Problems of this kind have not been experienced in Germany up to now. On the contrary: as explained above, short selling can also prove extremely beneficial to share issues (see our comments on share placements).

Disclosure and reporting of short sales

As a general point, it is important in any discussion of this issue to make a distinction between reporting short sales to the competent authorities and disclosure to the market.

The more detailed and prompt the disclosure of short sales to other market participants, the more likely it is that such a disclosure will have an adverse effect. First, there is a risk of a cornering of short sellers at the time of repurchase and, second, the short sales may be seen as an indication of falling prices, thus putting unnecessary pressure on the security. For these reasons, we reject the introduction of a requirement to disclose either naked or covered shorts to the market. But we also have reservations about a requirement to report short sales to supervisors since the resulting administrative burden would not be matched by any discernible benefit. The introduction of such a requirement would therefore be disproportionate, especially if intermediaries rather than the short sellers themselves were affected.

Although we fundamentally reject the idea of reporting requirements, our comments on their possible form – should they nevertheless be introduced – are as follows:

(i) Who will do the reporting?

The question of who will do the reporting is key to the issue of proportionality. Reports by intermediaries could only be based on the information available to them.

Responsibility for supplying an overview of a particular investor's total holdings can therefore only lie with the investor himself. Since intermediaries normally only have full information about the securities they themselves hold, they have no way of ascertaining whether their clients may have holdings of the security in question in another external

⁵ "A report to the Chancellor of the Exchequer" of November 2008 by the Rights Issue Review Group, available at : http://www.hm-treasury.gov.uk/d/pbr08_rightsissue_3050.pdf

account and thus whether a transaction really constitutes a short sale or not. Reports by intermediaries may therefore paint a false picture.

Should intermediaries be required to submit reports despite the concerns outlined above, use should be made of existing systems as far as possible. A possible solution would be for the intermediary to use these to send a consolidated report to the competent authority on a daily basis.

(ii) What to report and level of detail?

We would like to reiterate that we are fundamentally opposed to reporting requirements of any kind. If reporting requirements are nevertheless introduced, these should be limited to shares. The inclusion of listed derivatives would be particularly problematic because state interference of this kind could cause major disruption in the derivatives markets.

(iii) The trigger level of reporting?

We do not believe that a specific reporting threshold would be helpful because it would offer potential for circumventing requirements, especially for the purposes of market abuse. Given that aggregating various client holdings is an extremely complex task, especially where highly fungible securities are concerned, it would make good sense to set an error tolerance threshold, however.

(iii) Report to whom?

If a reporting system is introduced, the information should be reported using channels which already exist in member states. In Germany, reports are submitted direct to the competent authorities.

(iv) What information for public disclosure and how to disseminate and frequency of disclosure?

Should information have to be disclosed to the market, it is essential for such disclosure to take place only after a time-lag and in consolidated form. The disclosure of individual transactions would have undesirable consequences due to the potential response of other market participants. First, there would be a risk of a cornering of short sellers at the time of repurchase and, second, the short sales might be seen as an indication of falling prices, thus putting unnecessary pressure on the security.

Conclusion

Against the background of the considerable benefits delivered by short selling, we are of the opinion that a general ban cannot be justified. This includes naked short sales. In our view, the more effective response to the excessive short selling activities which seem to have occurred in some countries would be to change the present clearing and settlement rules. Compulsory buy-in procedures with appropriate sanctions would be particularly helpful. As things stand, we see no need for further action beyond these measures. Many of the approaches discussed at the moment would involve considerable cost and effort without delivering a matching improvement in the security and stability of the financial markets. In our eyes, this also holds true for the establishment of reporting requirements.

A task that we consider extremely important in this context is the harmonisation of the differing approaches to short selling taken to date by regulators across Europe. An integrated European financial market with intermediaries operating in many different jurisdictions needs a consistent set of rules.