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| Response Form to the Consultation Paper on the review of certain aspects of the Short Selling Regulation |
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**Responding to this paper**

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions. Comments are most helpful if they:

* respond to the question stated;
* indicate the specific question to which the comment relates;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

ESMA will consider all comments received by **19 November 2021.**

All contributions should be submitted online at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading ‘Your input - Consultations’.

**Instructions**

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.
2. use this form and send your responses in Word format (**pdf documents will not be considered except for annexes**);
3. Please do not remove tags of the type <ESMA\_QUESTION \_SSRR\_1>. **Your response to each question has to be framed by the two tags corresponding to the question.**
4. If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
5. When you have drafted your response, name your response form according to the following convention: ESMA\_SSRR\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_SSRR\_ABCD\_RESPONSEFORM.
6. Upload the form containing your responses, **in Word format**, to ESMA’s website (www.esma.europa.eu under the heading “Your input – Open Consultations” -> Consultation Paper on Review of MAR Guidelines on delay in the disclosure of inside information and interactions with prudential supervision”).

**Publication of responses**

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

**Data protection**

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading [Legal Notice](http://www.esma.europa.eu/legal-notice).

**Who should read this paper**

# All interested stakeholders are invited to respond to this consultation paper. This consultation paper is primarily of interest to issuers of financial instruments admitted to trading or traded on a trading venue, investment firms, market makers, primary dealers, persons who engage in short sales or transactions resulting in net short positions. Responses are also sought from any other market participant including trade associations and industry bodies, institutional and retail investors, consultants and academics.

**General information about respondent**

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| --- | --- |
| Name of the company / organisation | Muddy Waters Capital LLC |
| Activity | Investment Services |
| Are you representing an association? |  |
| Country/Region | North-America |

Please make your introductory comments below, if any.

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<ESMA\_QUESTION\_SSRR\_0>

1. Does ESMA’s analysis confirm the observation that you made in your perimeter of competency? Please provide data to support your views?

<ESMA\_QUESTION\_SSRR\_1>

ESMA’s analysis of short selling and its impact on financial markets reflects several important misunderstandings:

**1. Short selling does not amplify economic and financial crises**, to the contrary. First, short selling provides a hedge to long investments, giving long holders increased ability to maintain (rather than sell) their long positions in times of market dislocations. Moreover, in times of dislocation, every share sold short provides a potential bid for a stock when its price is in free fall, thereby acting as a price stabilizer – particularly when liquidity for value buyers is scarce, which it often is in sudden dislocations. ESMA should consider modern market structure when evaluating this last point.

The modern market has replaced a significant amount of active investment with passive investment in the floats of many companies. So long as inflows to passive funds are positive, these funds will buy at any price. However, once flows turn negative, they must sell indiscriminately. The preponderance of passive holders in the floats of many stocks has created significant fragility whereby there is a risk of a 1929 magnitude price crash, but at 2020 Covid dislocation speed. Given that active investors play a much smaller relative role in the modern market, restricting short selling during periods of dislocation can be self-defeating by removing a reliable bid that could establish higher floor prices.

**2. Short squeezes are not a justification to increase regulation of short selling.** Short selling is a niche strategy, practiced by a small fraction of equity market participants. Due to the asymmetrical nature of potential losses versus profits, it is inherently risky. It is not news to short sellers that squeezes can occur. Short selling requires a strong ability to manage risk, including the risk of squeezes. Rather than taking a paternalistic view toward short sellers by seeking to protect them from squeezes, ESMA should understand that short sellers acknowledge and accept these risks. That said, short sellers would welcome regulatory scrutiny of potential coordination of squeezes by large holders of lendable shares.

ESMA’s explicit reference to the US “meme stocks” trend of early 2021 to justify short selling regulation as a device for preventing short squeezes is also puzzling: the SEC’s report on the events which surrounded GameStop explicitly states that “the run-up in GME stock price coincided with buying by those with short positions. However, it also shows that such buying was a small fraction of overall buy volume, and that GME share prices continued to be high after the direct effects of covering short positions would have waned. The underlying motivation of such buy volume cannot be determined; perhaps it was motivated by the desire to maintain a short squeeze. Whether driven by a desire to squeeze short sellers and thus to profit from the resultant rise in price, or by belief in the fundamentals of GameStop, it was the positive sentiment, not the buying-to-cover, that sustained the weeks-long price appreciation of GameStop stock.’”[[1]](#footnote-2) In other words, ESMA’s fear of short squeezes, of which GameStop-related events supposedly were the most telling illustration, doesn’t appear substantiated by any concrete market phenomenon.

**3. Measures seeking to limit short selling activity lack any serious theoretical or empirical underpinning**. We do not believe that ESMA has ever proven the existence of a problem that its short selling regulation is intended to address. No serious study to date has ever substantiated the fears expressed by ESMA toward the supposed negative impact of short selling on the smooth operation of financial markets. This probably explains why ESMA only relies on one research paper, drafted by the Spanish market authority and only available in Spanish, to support its claim that short selling might have undesirable effects on financial markets. Furthermore, ESMA itself acknowledges in a footnote that “since this result is surprising and not in line with the literature, the authors point out that further research on this issue can be useful, especially since Amihud levels for Spanish securities were higher than their German control group -a difference that could have been caused by country risk.” We would also be curious to know more about “the literature [which] states that predatory short selling can contribute to the decline of stock prices and thus be responsible for a higher probability of default, especially for financial stocks and during crisis periods” that ESMA mentions without citing any paper supporting this statement.

ESMA’s stance is all the more surprising that its own literature review, exposed in section 7.2.2 of its consultation paper, is overwhelmingly unfavorable to short selling bans, and that the conclusion of its own empirical analysis, discussed in the same section, is contrasted at best. Furthermore, dozens of other academic studies have shown that short selling bans and other measures aimed at limiting short selling activity had a detrimental effect on financial markets, whether or not they were adopted in reaction to an economic or financial crisis.[[2]](#footnote-3) To the contrary, the academic literature reaching the opposite conclusion is virtually inexistent.

Instead of basing their decisions on relevant scientific evidence, market authorities tend to rely on the vague intuition that “short selling is bad,” using short sellers as handy scapegoats for the ills caused by economic and financial crises and market malfunctions. This is what happened in 2008 when the SEC suddenly adopted measured banning short sales in hundreds of stocks despite having concluded a year earlier that short sale restrictions that had been adopted in the aftermath of the Great Depression (where, again, short sellers were put under the spotlight) were in fact unjustified and should be abolished.[[3]](#footnote-4) Likewise, the French Financial Markets Authority (AMF), in a report discussing short selling bans adopted in reaction to the 2008 financial crisis, stated that “the exceptional regime was not intended to prevent the general price decline, which was obviously beyond its scope. Rather, it aimed more specifically to limit the downward price pressure resulting from short selling.”[[4]](#footnote-5) However, the same report stated how difficult it was to implement a scientific method as to determine whether or not the ban really limited the downward spiral, referring to a “general impression of skepticism” caused by the fact that short sales seemed to have more negative than positive effects when the ban was decided.[[5]](#footnote-6)

We urge ESMA to rely on scientific evidence rather than intuition and political pressure when considering possible answers to the Covid-19 crisis. Past experience and academic studies have univocally shown the complete inadequacy of short selling bans for this purpose.

<ESMA\_QUESTION\_SSRR\_1>

1. What are your views on the proposed clarifications?

<ESMA\_QUESTION\_SSRR\_2>

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<ESMA\_QUESTION\_SSRR\_2>

1. Do you agree with the proposed clarification?

<ESMA\_QUESTION\_SSRR\_3>

We exposed in Question 1 the reasons why short selling bans are a counterproductive answer to systemic risk. As a consequence, such measures always have the “detrimental effect on the efficiency of financial markets which is disproportionate to its benefit” that Article 20 of the Short Selling Regulation refers to. This means that there is no reason to allow Member states to adopt this kind of measure, whatever the economic and financial context. This exceptional power granted to national market authorities is all the more dangerous that national authorities can discretionarily decide short selling bans without properly demonstrating how they are actually useful in preventing systemic risk, at the risk of making considerable mistakes. The German BaFin’s decision to ban short sales of Wirecard’s shares for two months (a very long period that has been extremely costly to short sellers, who had been trying to get BaFin to take seriously their concerns about Wirecard, despite the complete absence of evidence justifying this measure) has demonstrated how problematic this can be. The ease with which Wirecard manipulated BaFin into seeking this ban should also give ESMA pause. ESMA’s positive opinion on this ban also illustrates the ineffectiveness of the obligation made to national market authorities to notify their decision to ESMA prior to its adoption. The power granted to national market authorities to decide short selling bans should therefore be purely and simply abrogated.

<ESMA\_QUESTION\_SSRR\_3>

1. What are your views regarding the exclusion or, alternatively, a percentage–based weighting approach, for indices, baskets and ETFs in the context of long – term bans?

<ESMA\_QUESTION\_SSRR\_4>

We have explained in our previous answers why short selling bans should be altogether forbidden. As a consequence, we welcome any restriction of the scope of these measures. The application of short selling bans to indices, baskets and ETFs is especially absurd for the reasons ESMA points out. Furthermore, the “anti-abuse provision” ESMA proposes to avoid circumventions of short selling bans through the use of indices, baskets and/or ETFs (assuming that such instruments are removed from the scope of short selling bans) would in our view be a needless source of legal uncertainty. Therefore, indices, baskets and ETFs should be purely and simply removed from the scope of short selling bans.

<ESMA\_QUESTION\_SSRR\_4>

1. Do you agree with the proposed alignment of the conditions to adopt measures under Article 20 and Article 28 of SSR?

<ESMA\_QUESTION\_SSRR\_5>

See answer to next question

<ESMA\_QUESTION\_SSRR\_5>

1. Do you agree with the proposed amendments to Article 24 of Delegated Regulation 918/2012?

<ESMA\_QUESTION\_SSRR\_6>

**Answer to questions 5 and 6:** We have explained in our previous answers why the possibility of deciding emergency measures limiting short selling activity should be altogether abrogated. We therefore oppose any amendment of the Short Selling Regulation whose consequence would be a loosening of the conditions under which ESMA is able to decide such measures.

<ESMA\_QUESTION\_SSRR\_6>

1. Do you agree with the proposed amendments to the SSR and, more specifically, the mediation procedure under Article 23 of SSR?

<ESMA\_QUESTION\_SSRR\_7>

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<ESMA\_QUESTION\_SSRR\_7>

1. What are your views on ESMA’s proposal to include subscription rights in the calculation of NSPs in shares?

<ESMA\_QUESTION\_SSRR\_8>

We agree with the argument that the inclusion of subscription rights in the calculation of long positions is the logical consequence of the inclusion of call options within this perimeter. As a consequence, we recommend including subscription rights in the calculation of long positions.

<ESMA\_QUESTION\_SSRR\_8>

1. Do you agree with this proposal to reinforce the third-party’s commitment? If not, please elaborate. If yes, would you either (A) keep the three types of locate arrangements, but increase the level of commitment of the third party to a firm commitment for all types of arrangements, or (B) simplify the regime to keep only one type of firm locate arrangement?

<ESMA\_QUESTION\_SSRR\_9>

The risk presented by naked short sales tends to be greatly overstated. It is entirely inappropriate for ESMA to speculate without any evidence that naked short selling could have occurred in GameStop. We note that when it comes to short selling, European attitudes more resemble those of shamans and witchdoctors than of scientists. If this sort of speculation is valid, we ask why ESMA is not concerned with the possibility of foreign powers having manipulated GameStop – or even aliens having manipulated it?

As the SEC’s report on the events which surrounded GameStop states, “fails to deliver can occur either with short or long sales, making them an imperfect measure of naked short selling. Moreover, based on the staff’s review of the available data, GME did not experience persistent fails to deliver at the individual clearing member level. Specifically, staff observed that most clearing members were able to clear any fails relatively quickly, i.e., within a few days, and for the most part did not experience fails across multiple days.”[[6]](#footnote-7) In other words, even in a case of significant short selling relative to the float (to which no European company has ever been even close), settlement failures ultimately had a very mild effect. Even more importantly, there was no evidence that these failures could be attributed to short sales (let alone naked ones).

While ESMA emphasizes short sales’ hypothetical shortcomings, it doesn’t say a word of the substantial perverse effects that reinforcing applicable rules to naked short sales could trigger. In particular, forcing broker-dealers to take a firm commitment to find shares when settlement comes due would make it considerably more difficult and expensive, for these broker-dealers, to transact with short sellers. It is conceivable that broker-dealers would significantly curtail their securities lending activity rather than risk liability. This outcome would harm the efficiency of European markets.

We are therefore unfavorable to any evolution of applicable rules that further the witch hunt for naked short selling, and in particular by forcing broker-dealers to take firm commitments to find shares when settlement comes due.

<ESMA\_QUESTION\_SSRR\_9>

1. Do you agree with this introducing a five-year-long record-keeping obligation for locate arrangements? If not, please justify your answer.

<ESMA\_QUESTION\_SSRR\_10>

Risks presented by naked short sales are significantly overstated, as discussed in our answer to Question 9. At the same time, the record-keeping obligation proposed by ESMA would be extremely burdensome for market actors regularly engaging in short sales, without this burden being justified by any public policy imperative. Even assuming that the supervision of naked short sales was a meaningful imperative and that a record-keeping obligation was the only way of ensuring effective supervision, a record-keeping obligation of a few months at a maximum would be clearly sufficient to reach supervisory objectives.

<ESMA\_QUESTION\_SSRR\_10>

1. Do you agree with reinforcing and harmonising sanctions for “naked short selling” along the proposed lines? If not, please justify your answer.

<ESMA\_QUESTION\_SSRR\_11>

Risks presented by naked short sales are significantly overstated, as discussed in our answer to Question 9. At the same time, the inherent complexity of short sales exposes investors to the risk of unintentionally violating their obligations, which discourages short sales generally despite short sellers’ crucial role in identifying overvalued companies and thus contributing to market efficiency. The extreme variability of sanctions that can be imposed by national market authorities contributes substantially to this uncertainty by being unduly burdensome. Imposing a minimal sanction at the European level would make the risks of short selling even greater than they already are without alleviating the uncertainty surrounding potential sanctions (due to the extremely high maximal pecuniary sanction and the absence of precise criteria or guidelines explaining how the amount of the sanction is actually computed). Thus, and although the harmonization of applicable rules at the European level is desirable as a matter of principle, ESMA’s proposal doesn’t adequately address the uncertainty surrounding applicable sanctions.

Furthermore, the maximum pecuniary sanction of EUR 100 million or ten times the profit realized or loss avoided is absurdly high, given that the hypothetical settlement risk presented by naked short sales has never been empirically verified (even in the caricatural example of GameStop). We are thus favorable to the harmonization of the existing sanction regime at the European level but would recommend a lowering of the maximal sanction rather than the introduction of a minimal threshold. Even more importantly, the calculation of the financial penalty should be based on clear criteria (profit made by breaching the rule, scienter, harms caused to third parties, etc.) rather than being left at the complete discretion of national market authorities. Absent such criteria, the harmonization of applicable sanctions to naked short sales will remain purely cosmetic.

<ESMA\_QUESTION\_SSRR\_11>

1. Do you consider that shares with only 40% of their turnover traded in a EU trading venue should remain subject to the full set of SSR obligations?

<ESMA\_QUESTION\_SSRR\_12>

We have explained in our answer to Question 1 why short sales aren’t a source of systemic risk, but rather contribute to alleviating it. Furthermore, we don’t understand what ESMA means by “abusive behavior” and “creation of disorderly trading conditions for the EU market.” Assuming ESMA refers to the risk of market manipulation, we would like to draw its attention to the fact that market manipulation through short sales isn’t likelier than manipulation through long positions, and that the Market Abuse Regulation already deals with this sort of issue. In any case, the concern express by ESMA about the risk posed by short selling seems purely hypothetical and isn’t substantiated by any concrete illustration, and no explanation is given as to the reason why lowering the threshold from 50% to 40% would be an adequate answer to this hypothetical risk. We are therefore unfavorable to the proposed extension of the scope of the Short Selling Regulation.

<ESMA\_QUESTION\_SSRR\_12>

1. Do you consider that NCAs should take any other qualitative but specific parameter into account in the identification of the shares subject to the full set of SSR obligations even if they are more heavily traded in a third-country venue? If yes, please elaborate

<ESMA\_QUESTION\_SSRR\_13>

We don’t understand the nature of the risk that ESMA seeks to address, as explained in our answer to Question 12. We are thus unable to answer this question.

<ESMA\_QUESTION\_SSRR\_13>

1. Would you modify the threshold for the public disclosure of significant NSPs in shares? If yes, at which level would you set it out? Please justify your answer, if possible, with quantitative data.

<ESMA\_QUESTION\_SSRR\_14>

ESMA’s analysis is partly correct: the information given to the market through the disclosure of net short positions, which undoubtedly contributes to the price informativeness of financial assets (hence to market efficiency), must be balanced with these disclosures’ negative impact in terms of investors’ incentives to engage in short sales when they believe that an issuer’s shares are overvalued (as disclosures send a negative signal which pushes the issuer’s price down and hence makes it more onerous for short sellers to borrow additional shares).

The issue is that nobody has ever been able to explain why such a low disclosure threshold as 0.5% of the issuer’s capital should be considered as striking the right balance between these two objectives. It seems to us that this threshold serves the interests of opacity by identifying to company managements the investors with whom they should avoid engaging. Thus, the existing disclosure regime discourages short selling.

Furthermore, there is no reason why short sellers should be subject to a lower disclosure threshold than long investors. Short sales simply are the converse of long positions. Nothing justifies giving the market more information about short sales than acquisitions of shares, thereby making the former costlier than the latter. If anything, short sales’ disclosure threshold should be higher than that of long positions: short sales are a very expensive technique for numerous reasons (borrowing costs, exposure to market manipulation techniques such as short squeezes, etc.), which justifies facilitating rather than putting unnecessary regulatory burdens on their implementation. Long position disclosures exist in order to alert the market of potential acquisitions of control stakes.

As a conclusion, we recommend amending existing public disclosure thresholds of short sales to align them with applicable thresholds to long positions, as nothing justifies that the former be lower than the latter. More generally, the disclosure regime of net short positions should be amended to align it fully with that of long positions (e.g., by giving short sellers four days to declare their threshold crossings, just as long investors).

<ESMA\_QUESTION\_SSRR\_14>

1. Would you agree with the publication of anonymised aggregated NSPs by issuer on a regular basis? If yes, which would be the adequate periodicity for that publication?

<ESMA\_QUESTION\_SSRR\_15>

We agree with the risk identified by ESMA: the publication of aggregated net short positions, including those positions which have been notified to the relevant competent authority but not to the market (because they represent at least 0.2% but less than 0.5% of the issuer’s share capital), may allow other market participants to figure out short sellers’ positions even when they are below 0.5%, to the detriment of market efficiency (for the reasons discussed in our answer to Question 14). Lowering the reporting threshold to market authorities from 0.2% to 0.1% (to which we are unfavorable, as it would impose an additional burden on short sellers which isn’t justified by any identified risk or problem) would only be a very imperfect remedy to this problem. We are therefore unfavorable to ESMA’s position and would recommend, at most, to include in the aggregated position calculation only those positions which are above the 0.5% threshold (and are thus already disclosed to the public).

<ESMA\_QUESTION\_SSRR\_15>

1. Have you detected problems in the identification of the issued share capital to fulfil the SSR notification/publication obligations? If yes, please describe and indicate how would you solve those issues.

<ESMA\_QUESTION\_SSRR\_16>

We would oppose any change in the regulations that would create additional data subscription burdens or oligopolies.

<ESMA\_QUESTION\_SSRR\_16>

1. Do you agree with the establishment of a centralised notification and publication system for natural and legal persons to communicate their NSPs? In your view, which would be the benefits or shortcomings this system would bring? Please explain.

<ESMA\_QUESTION\_SSRR\_17>

We believe that such a system would be an improvement of the existing system, from the perspective of both national market authorities and market participants, as it would avoid the regulatory burden and complexity of notifying net short positions to various national market authorities. We are therefore favorable to ESMA’s recommendation.

<ESMA\_QUESTION\_SSRR\_17>

1. SEC, *Staff Report on Equity and Options Market Structure Conditions in Early 2021*, 14 October 2021, p. 26. [↑](#footnote-ref-2)
2. See for instance A. Curtis, N. Fargher, *Does short-selling amplify price declines or align stocks with their fundamental values ?,* September 2009; Alan D. Crane, Kevin Crotty, Sébastien Michenaud, and Patricia Naranjo. “T*he Causal Effects of Short-Selling Bans: Evidence from Eligibility Thresholds.*”The Review of Asset Pricing Studies 9, no. 1 (2019):137–170; Pasquale Della Corte, Robert Kosowski, and Nikolaos Rapanos. “*Short-Selling Bans in Europe: Evidence from the COVID-19 Pandemi*c”2020; W. Bessler, M. Vendrasco, “The 2020 European Short-Selling Ban And The Effect On Market Quality”, 21 december 2020. [↑](#footnote-ref-3)
3. Ekkehart Boehmer, Charles M. Jones and Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban* (Oxford University Press) 2013. [↑](#footnote-ref-4)
4. AMF, Rapport du groupe de travail sur les ventes à découvert, Groupe de travail animé par Marie-Ange Debon et Jean-Pierre Hellebuyck, Membres du Collège de l’AMF 23 février 2009, p. 11. [↑](#footnote-ref-5)
5. idem [↑](#footnote-ref-6)
6. SEC, *Staff Report on Equity and Options Market Structure Conditions in Early 2021*, 14 October 2021, p. 29. [↑](#footnote-ref-7)