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The Monte dei Paschi affaire: distressed banks and the European regulation on short selling

Marco Dell'Erba* and Giovanni Patti**

Key points

- The European short selling regulation (SSR) has been applied to restrict hedge funds from short selling the stock of Monte dei Paschi di Siena (MPS) as part of a distressed securities strategy.
- In the MPS case, a distressed securities strategy was carried out based on short selling, despite the adoption of a temporary ban on short selling by means of purchasing put options from a market maker.
- Article 23 of the SSR provides that the national competent authorities (NCAs) may prohibit or restrict the execution of short sales in the event of a decrease in price by a given percentage during a single day's trading for a given financial instrument.
- The temporary ban on short selling adopted by the NCAs or the ESMA under the SSR can be circumvented by means of an indirect use of the market making exemption.
- When adopting the ban and conceding the market making exemption, we take the view that the NCAs and the ESMA should require market makers to prohibit investors from increasing their net short positions in the focal stock.

1. Introduction

In this article, we analyse the manner in which the European regulation on short selling regulation¹ (SSR) has been applied to restrict hedge funds from short selling² the stock of Monte dei Paschi di Siena (MPS) as part of a distressed securities strategy. In addition, we formulate some policy considerations regarding how to make the SSR more effective by

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1 Regulation (EU) n 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.

2 See SEC, 'Fast Answers' <<https://www.sec.gov/answers/shortsale.htm>> accessed 30 July 2016 (as defined by the SEC, a short sale is 'the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor').

Under the SSR, a sale of shares or debt instruments qualifies as a 'short sale' when the seller 'does not own' the security 'at the time of entering into the agreement to sell' and it includes those cases 'where at the time of entering into the agreement to sell the seller has borrowed or agreed to borrow the share or debt instrument for delivery at settlement', see SSR, art 2(1)(b). Moreover, under the SSR, the definition of 'short sale' refers only to 'shares' and 'debt instruments', whereas other financial instruments including, inter alia, 'futures contracts' and—more generally—any 'other derivative contract where it is agreed to sell securities at a specified price at a future date' are explicitly excluded from that definition (see SSR, art 2(1)(b)(iii)).

As to the definition of 'short position', in the SSR this expression refers not only to the case of 'a short sale of a share issued by a company or of a debt instrument issued by a sovereign issuer' (see SSR, art 3(1)(a)) but also to any other financial instrument that gives the opportunity to make a profit in the event of a decrease in the value of a share or a debt instrument (see SSR, art 3(1)(b)).

preventing circumvention of the type of temporary short sale restriction adopted in the MPS case.

As will be detailed further below, bad management decisions and illegal activities in the MPS case hurt the financial stability of one of the world's oldest banks. Coupled with other factors (inter alia, the European sovereign debt crisis), this situation has spurred speculative ideas among hedge funds in search of troubled assets. Financial speculation and hedge funds as the main vehicle of financial instability, opacity and excessive leverage have been a topical issue in the debate on financial regulation during and in the aftermath of the financial crisis of 2008. Regulators around the world have continuously debated the wisdom of providing stricter regulations for financial innovation, alternative funds, and alternative investment strategies that are based mainly on leverage, derivatives and short selling.

It is widely believed that hedge funds did not cause the financial crisis of 2008 but were instead a channel through which specific consequences of the financial crises were propagated, amplified and ultimately transmitted in the financial markets and the real economy. For instance, the de Larosière Report stated that the role of hedge funds in the financial crisis has 'largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions'.³

Following the financial crisis of 2008, hedge funds have made significant investments in companies operating in sectors that remain either exposed to the negative consequences of the financial crisis (notably the European banking sector) or affected by the new negative market conditions (such as the oil and gas sector).⁴ In these sectors, hedge funds have been playing prominent roles while using 'distressed securities strategies'.

Distressed securities strategies target the securities of companies that are already under bankruptcy protection or that show serious signs of an imminent default.⁵ The most common distressed strategy consists of buying the corporate bonds of companies that are experiencing financial issues or of buying banks' non-performing loans at a discount. Another common strategy involves buying the stock of a distressed company, holding it during the company's reorganization, and ultimately selling it at a higher price after successful reorganization. In addition, distressed strategies may also be undertaken by short selling the stock of a distressed company with the goal of profiting from its

3 The High-Level Group of Financial Supervision in the EU (Chaired by Jacques de Larosière), Report (25 February 2009), para 86 <http://ec.europa.eu/finance/general-policy/docs/de_larosiere_report_en.pdf> accessed 30 July 2016; see also Charles River Associates, 'Impact of the Proposed AIFM Directive Across Europe, Study for the FSA' (October 2009), para 5.1 <http://www.fvca.fi/files/52/Impact_of_AIFM_Directive_FSA_1009.pdf> accessed 30 July 2016; Roberta Romano, 'Against Financial Regulation Harmonization: A Comment' (20 November 2010) Yale Law & Economics Research Paper No 414 <<http://ssrn.com/abstract=1697348>> accessed 30 July 2016.

4 See Matt Wirz, 'Energy Sector Draws Investors in Distressed Securities' *Wall Street Journal* (12 February 2015) (describing the different strategies by which distressed investors are profiting from the crisis experienced by the oil sector).

5 See 'Distressed Securities' <http://www.hedgefund-index.com/d_distressed.asp> accessed 30 July 2016; Gregory Connor and Teo Lasarte, 'An Introduction to Hedge Fund Strategies' <<https://www.iam.uk.com/Portals/0/pdf/lse-publications/An-Introduction-to-Hedge-Funds.pdf>> accessed 30 July 2016.

declining stock price.⁶ Finally, in certain cases, the distressed strategies may consist of a combination of the strategies discussed above.

During the financial crisis of 2008, an emblematic transaction involving the use of distressed strategies was the acquisition of the IndyMac Bank (one of the largest savings and loan associations that defaulted during the crisis)⁷ by a consortium of hedge funds and private-equity funds.⁸ In the wake of the financial crisis, investment opportunities for hedge funds focused on distressed companies have increased in connection with the financial instability experienced by several European commercial banks. In this context, Italian credit institutions have been particularly exposed to difficult market conditions, mostly as the result of the quality of the so-called non-performing loans held on their balance sheets.⁹ Among these credit institutions, MPS has become an appealing target for hedge funds during the restructuring process (which began years ago and remains in progress). Hedge funds have put in place almost all kinds of distressed securities strategies, including those implemented through short selling.

The transactions resulting from such investment strategies caused the intervention by the Italian competent authority (CONSOB) by means of the ‘extraordinary powers’ granted by the SSR. From the CONSOB perspective, the measures adopted were necessary to mitigate the effects of these distressed securities strategies on MPS stock prices, with the goal of safeguarding not only the restructuring process of the bank but also—from a broader perspective—the stability of the overall Italian banking sector.

In the aftermath of the 2008 financial crisis, the vast majority of regulators addressed short selling, in particular naked short selling,¹⁰ as a potential source of systemic risk. Both the American and European regulators adopted several types of measures, particularly in the form of bans on short selling,¹¹ on the assumption that such measures would alleviate the severity of price declines and market panic. In Europe, the SSR codified some of the measures adopted over the years by American and English regulators. In particular, Articles 18, 19, 20, 21 and 23 of the SSR authorize the intervention (by means of ‘extraordinary powers’) of the European Securities and Market Authority (ESMA) and of the NCAs in ‘exceptional circumstances’ (Articles 18, 19, 20 and 21) and ‘in the case of a significant fall in price’ (Article 23). The latter type of intervention authorized by the SSR was relevant in the MPS case.

6 From an economic perspective, short selling consists in the practice of selling securities not owned by the seller at the time of the sale with the purpose to benefit from a decrease in the price of the securities, see *ex multis* Short Sales (Final rule), Exchange Act Release No 34-50103, 69 Fed Reg 48,008 (6 August 2004), 17 CFR 240, 241 and 242.

7 Kowe Zachery, ‘IndyMac Is Set to Be Sold to Private Investors’ *New York Times (Dealbook)* (27 December 2008).

8 See Zachary R Mider and Ian Katz, ‘Mnuchin Leads Private-Equity Funds to Buy Failed IndyMac Bank’ *Bloomberg* (3 January 2009).

9 See Giovanni Legorano, ‘Bad Debt Piled in Italian Banks Looms as Next Crisis’ *Wall Street Journal* (4 July 2016).

10 As explained by the SEC, in ‘Key Points About Regulation SHO’ <<https://www.sec.gov/investor/pubs/regsho.htm#ftn1>> accessed 30 July 2016, ‘In a ‘naked’ short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period’.

11 See Seraina Gruenewald, Alexander F Wagner and Rolf H Weber, ‘Emergency Short Selling Restrictions in the Course of the Financial Crisis’ (22 June 2010) <<http://ssrn.com/abstract=1441236>> accessed 30 July 2016.

In this article, we will examine short selling as a distressed securities strategy in the MPS case and the consequent restrictions adopted by CONSOB under the SSR. The results obtained by this examination offer us the opportunity to assess the effectiveness of the European regulatory framework on short selling. Indeed, in the MPS case, a distressed securities strategy was carried out by some speculators, despite the adoption of a temporary ban on short selling, by means of purchasing put options from a market maker. Therefore, we note that under specific circumstances the NCAs must reconsider the ways in which they grant the 'market making exemption' so as to effectively impede the circumvention of the temporary ban on short selling introduced by an NCA pursuant to the 'extraordinary powers' granted by the SSR.

For the sake of clarity, this article does not address the issue of whether the ban on short selling is a valuable tool to restore market confidence and to curb stocks' volatility. Furthermore, it is not meant to cast doubt on the possibility of granting a market making exemption in the context of the adoption of a temporary ban. Instead, this policy-oriented analysis is focused exclusively on the conditions that should necessarily be met when conceding the market making exemption to avoid any investors' attempt to circumvent a temporary ban on short selling adopted under the SSR.

The remainder of this article is structured as follows. Section 2 outlines the European regulatory framework on short selling with a special focus on the public extraordinary powers of intervention pursuant to Articles 18, 19, 20, 21 and 23 of the SSR. Section 3 provides a description of the facts that led to MPS's financial instability, the different trading strategies implemented by hedge funds and the countermeasures adopted by CONSOB to shield the bank from speculative attacks. Section 4 specifically analyses the market making exemption and the ways in which this exemption is commonly used. In Section 5, we express our policy recommendations to make the temporary restriction more effective after its adoption. In Section 6, we draw our conclusions.

2. The public extraordinary powers of intervention in the European regulation on short selling

The SSR was adopted after the financial crisis of 2008, in the midst of the European sovereign debt crisis. In that context, the EU regulatory intervention on short selling was mainly driven by the opportunity to achieve a certain level of harmonization among EU Member States' legislations on short selling. The need for harmonization in connection with the execution of this trading strategy in the European financial markets was initially expressed in 2009 by the Committee of European Securities Regulators (CESR) in light of the substantial differences in the short selling restrictions adopted by the EU Member

States in the second half of 2008, at the peak of the financial crisis.¹² In this context, the CESR considered to be reasonable the worries—expressed by market participants—about ‘the burdens of having to comply with a number of different sets of national requirements’, thus it proposed to the European Commission the introduction of a permanent European disclosure system on short selling.¹³

Regulatory fragmentation related to short selling had also become a concern for the European Commission. In its ‘Impact Assessment’ regarding the proposal for regulation on short selling,¹⁴ the European Commission noted that regulatory fragmentation on short selling would have led to an increase in compliance costs for market participants and potential regulatory arbitrage.¹⁵ In addition to regulatory fragmentation, the Commission identified further issues associated with short selling, including the risk of negative price spirals during distressed markets, the risk of settlement failures related to the practice of naked short selling and the risk of transparency deficiencies.¹⁶

The SSR provides a set of ‘permanent’ requirements and restrictions related to short selling and, in addition, it provides a set of ‘extraordinary powers’ of intervention that NCAs and the ESMA may use to adopt ‘temporary’ restrictions in ‘exceptional circumstances’ (Articles 18, 19, 20 and 21) or ‘in the case of a significant fall in price’ (Article 23).¹⁷ In the following paragraphs, we conduct an analysis of these ‘extraordinary powers’ in the way they were employed in the MPS case as ‘temporary’ countermeasures against certain distressed securities strategies implemented by means of short selling in the midst of MPS’s reorganization process.

The ‘extraordinary powers’ that NCAs and the ESMA may exercise in ‘exceptional circumstances’¹⁸ or ‘in the case of a significant fall in price’¹⁹ permit the adoption of

12 See CESR, ‘Proposal for a Pan-European Short Selling Disclosure Regime’ (8 July 2009), 3, accessed 30 July 2016 (hereinafter, ‘CESR Proposal’). For a comment on the CESR report see ‘CESR Model for a Permanent Pan-European Short Selling Disclosure Regime’, Sherman & Sterling, Client Publication (15 March 2010).

For a full analysis of the different interventions adopted by the different Member States, see European Commission, ‘Commission Staff Working Document Impact Assessment, Accompanying document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps’ (2010), Annex III (hereinafter, ‘EU Commission Impact Assessment’); Sherman & Sterling, ‘Global Clampdown on Short Selling: an Overview’ (12 February 2010); ESMA, ‘Measures Adopted by Competent Authorities on Short Selling’ (31 January 2011) and ESMA, ‘Update on Measures Adopted by Competent Authorities on Short Selling’ (21 November 2011).

13 See *CESR Proposal* (n 12), at 3.

14 See *EU Commission Impact Assessment* (n 12) 20–22.

15 See *EU Commission Impact Assessment* (n 12) 3.

16 See *EU Commission Impact Assessment* (n 12) 20–22. See also European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps’ (September 2010).

17 For some comments about the SSR, see White & Case, ‘The EU Short Selling Regulation comes into force’ (November 2012); Credit Suisse, ‘The “Regulation on Short Selling and Certain Aspects of CDS”’ (17 October 2012) Credit Suisse Securities Research & Analytics; Rodolphe B Elineau, ‘Regulating Short Selling in Europe After the Crisis’ (2012) 8 Int’l L & Mgmt Rev 61; Milosz Morgut, ‘Let Cassandra Speak – Short Selling in the European Union’ (2012) 18 Colum J Eur L 6; Jennifer Payne, ‘The Regulation of Short Selling and Its Reform in Europe’ (2012) 13 EBOR 413; Niahm Moloney, ‘EU Securities and Financial Markets Regulation’ (3rd edn, Oxford EU Law Library 2014) 538; Fabian Walla, ‘Short Selling’ in Rüdiger Veil (ed), *European Capital Markets Law* (1st edn, Hart Publishing 2013) 201; Wolf-Georg Ringe, *The Deconstruction of Equity Activist Shareholders, Decoupled Risk, and Corporate Governance* (OUP 2016) 183.

18 See SSR, arts 18, 19, 20 and 21.

19 See SSR, art 23.

'temporary' restrictions²⁰ that in some respects are akin to those that are permanently in place pursuant to the other rules in the SSR, making the overall legal regime on short selling 'temporarily' even more stringent. The 'permanent' requirements provided by the SSR include the following: (i) a transparency regime for net short positions;²¹ (ii) the conditions for the execution of short selling of shares that are admitted to trading on a trading venue;²² (iii) the conditions for the execution of short sales of sovereign debt;²³ and (iv) a general prohibition against uncovered sovereign credit default swaps.²⁴

As to the 'temporary' restrictions, we first need to consider those that the NCAs and the ESMA may adopt in 'exceptional circumstances', namely: the imposition of notification and disclosure obligations (Articles 18 and 19) and, in addition, the adoption of restrictions on short selling and sovereign credit default swap (Articles 20 and 21). More specifically, Article 18 allows the NCAs to impose notification and disclosure obligations, on a 'temporary' basis, in the event of the occurrence of 'exceptional circumstances'. These obligations are similar to the notification and disclosure obligations that respectively Articles 5 and 6 impose, on a 'permanent' basis, when short sellers' net short positions reach or fall below 'a relevant notification threshold' or 'a relevant publication threshold'. Article 18 thus allows the NCAs to impose, on a 'temporary' basis, notification or disclosure obligations similar to those contained in Articles 5 and 6 should 'exceptional circumstances' occur and should investors' net short positions reach or fall below a threshold—other than those specified in Articles 5 and 6—and that the NCAs are authorized to fix.²⁵

A further measure that the NCAs may adopt in 'exceptional circumstances' is the one provided in Article 19 and consisting in requiring lenders on a specific financial instrument or on a class of financial instruments to notify the relevant parties regarding 'any significant change in the fees requested for such lending'.²⁶ However, the most relevant provision is arguably the one contained in Article 20. Indeed, this provision grants the power to temporarily 'prohibit' or 'impose conditions' on the execution of short sales, both covered and naked.²⁷ In other words, this provision allows the NCAs to

20 The measures provided in arts 18, 19, 20 and 21 may have a duration not exceeding three months and they can be renewed for further periods not exceeding three months, see SSR, art 24.

21 See SSR, arts 5–11.

22 See SSR, art 12.

23 See SSR, art 13, containing the so-called 'locate requirement'. The locate requirement includes the following conditions, at least one of which must be fulfilled by the short seller for the execution of a short sale: (i) the short seller 'has borrowed the share or has made alternative provisions resulting in a similar legal effects'; (ii) the short seller 'has entered into an agreement to borrow the share or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due'; (iii) the short seller 'has an arrangement with a third party under which that third party has confirmed that the share has been located and has taken measures vis-à-vis third parties necessary for the natural or legal person to have a reasonable expectation that settlement can be effected when it is due'.

24 See SSR, art 14.

25 See SSR, art 18. Pursuant to art 5(2), '[a] relevant notification threshold is a percentage that equals 0,2% of the issued share capital of the company concerned and each 0,1% above that'. Pursuant to art 6(2), '[a] relevant publication threshold is a percentage that equals 0,5% of the issued share capital of the company concerned and each 0,1% above that'.

26 See SSR, art 19. However, this type of measure is not prescribed by the SSR on a permanent basis and would therefore exist only if introduced temporarily by a NCA or the ESMA.

27 See SSR, art 20.

‘temporarily’ ban short selling. This type of restriction may have a broad impact since it can be introduced not only with reference to ‘a specific financial instrument’ but also with reference to ‘all financial instruments’ or to ‘financial instruments of a specific class’.²⁸ Finally, Article 21 allows the NCA to restrict the ability to enter into credit default swap transactions or to ‘limit the value of sovereign credit default swap positions’ that an investor can take.²⁹

As discussed above, the measures that the NCAs and the ESMA may adopt pursuant to Articles 18, 19, 20 and 21 require the presence of ‘exceptional circumstances’. Such events are defined as ‘adverse events or developments which constitute a serious threat to financial stability or to market confidence in the Member State concerned’.³⁰ However, the existence of these circumstances alone is not sufficient for the NCAs to adopt any restriction because costs (in terms of market inefficiency) shall not be disproportionate to benefits.³¹ Moreover, as specified in Article 24, the restrictions may be adopted for a maximum of three months and may be renewed for further three-month periods.³²

The other category of ‘extraordinary powers’ is represented by those powers that the NCAs and the ESMA may adopt ‘in the case of a significant fall in price’. In particular, Article 23 provides that the NCAs may prohibit or restrict the execution of short sales in the event of a decrease in price by a given percentage during a single day’s trading for a given financial instrument.³³ The percentage depends on the type of financial instrument, ie for liquid shares it is set at 10 per cent, whereas the percentage for illiquid shares must be specified by the European Commission.³⁴ This type of restriction may remain in place until the end of the day following the trading day during which the significant decline has occurred, whereas an extension of the restriction may be adopted only for two days following a further significant fall.³⁵

The measures that can be adopted pursuant to Article 23 resemble those restrictions provided by Rule 201 of Regulation SHO in the USA.³⁶ In contrast to the European regime, the restriction in the USA is a circuit breaker; therefore, it operates automatically once the stock price falls by 10 per cent or more in a single day, while in Europe, under Article 23, when the price falls below the threshold, the NCA ‘shall consider whether it is

28 See SSR, art 20(3).

29 See SSR, art 21.

30 See SSR, arts 18(1)(a), 19(1)(a), 20(1)(a) and 21(1)(a).

31 See SSR, art 18(1)(b), art 19(1)(b), art 20(1)(b) and art 21(1)(b).

32 See SSR, art 24.

33 See SSR, art 23. As we will note in our analysis in Sections 4 and 5, when adopting a measure pursuant to art 23, the NCAs can introduce exemptions with regard to market making activities and primary market activities.

34 With regard to the qualification of shares as ‘liquid’ or ‘illiquid’, art 22 of the Commission Regulation (EC) No 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC (Mifid), provides that ‘A share admitted to trading on a regulated market shall be considered to have a liquid market if the share is traded daily, with a free float not less than EUR 500 million, and one of the following conditions is satisfied: (a) the average daily number of transactions in the share is not less than 500; (b) the average daily turnover for the share is not less than EUR 2 million’.

35 See SSR, art 23(2). Such a drop in value should be equal at least 5% for liquid shares, whereas for illiquid shares, it must be equal to at least half of the percentage set by the Commission pursuant to art 23(5).

36 See Amendments to Regulation Short Sales (Final rule), Exchange Act Release No 34-61595, 75 Fed Reg 11,232 (26 February 2010), 17 CFR 242. For a comment of Rule 201 of Regulation SHO, see *ex multis* Shearman & Sterling, ‘Short Sales: A New Circuit Breaker’ (March 2010).

appropriate to prohibit' the execution of short sales. In addition, we need to consider that, in the USA, once the circuit breaker is triggered, the prohibition will be effective only with regard to the 'execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid';³⁷ whereas in Europe, once the restriction is adopted, short selling is prohibited absolutely.

Therefore, the American regulation is based on the presumption that the intraday volatility of a given stock is likely to be the result of speculative short-term market movements and that short selling would put further downwards pressure on the stock. In this context, the American regulator deems it necessary to give long sellers a chance to sell before short sellers. In Europe, such a presumption is not absolute, and the protection of long holders is therefore subordinated to an evaluation by the NCA of the factors that are relevant in an overall sense in any specific situation. Thus, at least from a theoretical perspective, the European regulation appears less stringent than the American, although the former is attempting to mimic the latter. Nonetheless, it is likely that, should a price decrease be equal to or greater than 10 per cent in a single day, the NCAs will automatically react by introducing restrictions on the execution of short selling pursuant to Article 23. This scenario seems especially likely given that the provision does not specify which other factors (beyond the stock price decline) should be taken into account by the NCA when deciding whether to adopt the restriction. Therefore, it is likely that one factor that will be considered will be whether there are rumours reported by the financial press regarding speculative manoeuvres involving the specific stock that is experiencing the intraday price decline equal to or greater than the 10 per cent threshold.

Moreover, as reported above, the short sale restriction pursuant to Article 23 may be extended, under some conditions, only once. Therefore, if during the day following the expiration of the extended restriction, the stock price experiences another significant decline, it is highly likely that the NCA will adopt a restriction under Article 20, namely a 'temporary' ban on short selling based on 'exceptional circumstances'.

Always in the context of the 'extraordinary powers' and from an institutional perspective regarding the architecture of the SSR, ESMA has a role of 'facilitation and coordination' in relation to the measures that NCAs may adopt 'in exceptional circumstances' or 'in the case of a significant fall in price'.³⁸ This role is meant to ensure a consistent approach with regard to taking measures, both in terms of their nature and duration.³⁹

In particular, the ESMA may issue an opinion regarding the intention of an NCA to adopt or renew a restriction on short selling 'in exceptional circumstances' (pursuant to Articles 18, 19, 20 and 21).⁴⁰ Before imposing or renewing such a restriction, the NCAs must notify the ESMA of the proposal regarding the measure, which should explain the reasons and provide the evidence for the measure, while outlining the instruments and

37 See § 242.201(b)(1)(i) of Regulation SHO.

38 See SSR, art 27(1).

39 See SSR, art 27(1).

40 See SSR, art 27(2).

transactions that will be subject to the restriction and providing details regarding when the restriction will take effect.⁴¹ The ESMA must provide its opinion regarding whether all the conditions are met and whether the measure is ‘appropriate and proportionate’. In addition, in ‘exceptional circumstances’, the ESMA is empowered to impose notification or disclosure obligations on short sellers regarding net short positions⁴² and to prohibit or impose conditions on market participants with regard to executing a short sale or an equivalent economic transaction involving alternative financial instruments.⁴³

However, exercising such powers of intervention is subject to the existence of cross-border implications and to the lack of any measures adopted by one or more NCA.⁴⁴ In addition, from a systemic perspective, the ESMA is required to take into account the orderly functioning and integrity of financial markets, the risk of regulatory arbitrage and the efficiency of the financial markets.⁴⁵

In ‘UK versus Council and Parliament’ in 2014,⁴⁶ the European Court of Justice (ECJ) was called on to specify the nature and boundaries of the powers of the ESMA in the context of ‘exceptional circumstances’. The ECJ qualified the powers of the ESMA as non-discretionary, arguing that the execution of such powers of intervention by the ESMA is the basis of an ‘appropriate mechanism which would enable, as a last resort and in specific circumstances, measures to be adopted throughout the EU which may take the form, where necessary, of decisions directed at certain participants in those markets’.⁴⁷ Moreover, the Court noted not only that the exercise of the powers under Article 28 of the SSR circumscribed by various conditions and criteria limit the ESMA’s discretion⁴⁸ but also that the ESMA shall consult the European Systemic Risk Board before the adoption of its decision and (where appropriate) other relevant authorities.⁴⁹

3. Short sellers and the Monte dei Paschi affaire

In recent years, MPS has been at the epicentre of a stream of financial and judiciary chronicles. The financial troubles experienced by the bank epitomize the downsides of the overall Italian banking sector. Given the relevance of banks as systemic entities, its fate has been perceived as crucial to restoring investor confidence in the banking sector and ultimately in the economy of one of the most important Member States in the EU.⁵⁰

41 See SSR, art 26. The same notification is required when an NCA intends to adopt a restriction in the case of a significant fall in price pursuant to art 23.

42 See SSR, art 28(1)(a).

43 See SSR, art 28(1)(b).

44 See SSR, art 28(2).

45 See SSR, art 28(3).

46 The case arose from the action brought in May 2012 by the UK with the intention of claiming an annulment of art 28 of the SSR, considered the discretionary power conferred to the ESMA and the incorrect legal basis of art 114 TFEU for the adoption of rules set forth by art 28(1).

47 Case C-270/12 *United Kingdom v Parliament and Council* [2014] ECLI:EU:C:2014:18 (hereinafter, ‘Case C-270/12’).

48 See Case C-270/12 (n 47), para 45.

49 See Case C-270/12 (n 47), para 50.

50 See International Monetary Fund, ‘Italy: Financial System Stability Assessment’ 7, 13-15 (IMF Country Report No 13/300, 2013) (where with specific reference to MPS it is stated that ‘Successful implementation of the ambitious restructuring plan is critical not only for the bank itself but also for the system as a whole’).

MPS's financial troubles have their main roots in the losses registered by the bank in connection with two derivative contracts named 'Alexandria' and 'Santorini' that were signed in 2007 and 2009 with Nomura Bank and Deutsche Bank, respectively. The two main objectives of these two derivative contracts involved the restructuring of a pre-existing investment made by MPS⁵¹ and to hide previous losses.⁵² The losses related to the two contracts were discovered in the context of a wider examination of MPS's financial conditions by the Bank of Italy. This examination was conducted by the Bank of Italy after MPS requested approval for the acquisition of another Italian bank, Banca Antonveneta. The examination revealed that MPS's former management had hidden the actual amount of the losses related to the two contracts not only from the board of directors but also from the bank's accountants and from those authorities with oversight power regarding MPS's activities (Bank of Italy and CONSOB).⁵³

These facts—coupled with other negative macroeconomics trends (eg the European sovereign debt crisis)—undermined the financial stability of the bank and ultimately attracted investments by sophisticated investors. These investments were implemented during the bank's reorganization process by means of some of the most common distressed securities strategies: the purchase of MPS stock at a substantially deflated price in a calculated gamble on a future price increase; the purchase of the non-performing loans held by the bank; the short sales of the bank's stock; and ultimately by means of a combination of the above-mentioned strategies.⁵⁴

In the MPS case, distressed securities strategies executed through the use of short selling have led to (in certain specific situations) interventions by the Italian competent authority in accordance with the above examined 'extraordinary powers' provided by the SSR. In the following paragraphs, we will examine the manner in which these short selling-based strategies have been implemented and the countermeasures adopted by CONSOB.

In January 2013, after the examinations of MPS by the Bank of Italy, three hedge funds (Odey Asset Management, Egerton Capital and Wellington Management Company) took significant short positions on MPS's stock.⁵⁵ The uncertainty surrounding the significant

51 Robin Harding and Patrick McGee, 'Nomura Books \$290m Loss over Monte dei Paschi Settlement' *Financial Times* (24 September 2015) (hereinafter, 'Nomura Books \$290m Loss').

52 Elisa Martinuzzi and Sonia Sirletti, 'Deutsche Bank Forfeits 221 Million Euros from Monte Paschi Deal' *Bloomberg Business* (20 December 2013).

53 See Banca d'Italia, 'Principali interventi di vigilanza sul gruppo Monte dei Paschi di Siena' (May 2013) <<https://www.bancaditalia.it/media/approfondimenti/2013/interventi-gruppo-mps/index.html>> accessed 30 July 2016.

For these illegal activities, the former top executives of the bank were sentenced and still face additional criminal charges. See Harding and McGee, *Nomura Books \$290m Loss* (n 51); Giovanni Legorano and Jenny Strasburg, 'Current and Former MPS, Deutsche Bank, Nomura Executives Charged in Italy' *Wall Street Journal* (1 October 2016). Moreover, in an attempt to remedy the huge losses experienced by the bank's shareholders, the new management took legal actions against Nomura Bank and Deutsche Bank. These litigation actions were ultimately settled in December 2013 with Deutsche Bank in connection with the 'Santorini' derivative contract and with Nomura Bank in September 2015 in connection with the 'Alexandria' derivative contract.

54 Some investors have also attempted to speculate by means of illegal activities, such as the announcement by Nit Holdings Limited of a proposal to invest 10 billion euros in the bank that was not actually received by the bank, see Francesca Pulella and Philip Pulella, 'Monte Paschi Says Knows Nothing about NIT 10 Billion Euro Offer' *Reuters* (3 November 2014).

55 Laurence Fletcher, 'Hedge Funds Up Bets against Italy's Monte Paschi' *Reuters* (3 February 2013) (hereinafter, 'Hedge funds up bets').

losses stemming from the derivative contracts discussed above—referred to as Alessandria and Santorini—created profitable conditions for betting against the bank. This led to MPS shares being the most demanded shares in Italy's FTSE MIB—FTMIB blue-chip index for short-selling by hedge funds during that period.⁵⁶

Short sellers' activities regarding MPS stock picked up on 2 April 2013, leading to a fall in price of more than 10 per cent that triggered the intervention by CONSOB. The first measure adopted by the Italian market authority to curb short sellers was a temporary ban (until the end of the next trading day) on short selling of MPS shares based on Article 23 of the SSR.⁵⁷ Simultaneously, CONSOB granted an exemption from the ban for market makers based on Article 23(3) of the SSR.

In early 2014, certain hedge funds (Paulson & Co, York Capital, Marshall Wace, Tosca and Guggenheim) took long positions in MPS shares by subscribing the bank's capital increase,⁵⁸ thus betting that the bank would fix its financial troubles. However, during the same year, the short selling activity on MPS shares resumed again, leading CONSOB to adopt four resolutions based on Article 23 of the SSR⁵⁹ and two resolutions based on Article 20 of the SSR.⁶⁰ The four resolutions based on Article 23 of the SSR were adopted on the grounds that MPS shares experienced high intraday volatility that reduced the price of the shares by more than 10 per cent in a single day. By means of the resolutions based on Article 20, CONSOB introduced a longer ban on short selling related to the volatility of the shares that stemmed from the 'results of the Comprehensive Assessment carried out by the European Central Bank, which showed capital shortfalls for BMPS'.⁶¹ Indeed, the prohibition was initially in place from 27 October 2014 until 10 November 2014 and it was then renewed for the period from the 11th to the 27th of January 2015. Moreover, both the ban and the renewal provided an exemption for market making activities. In its opinion regarding the measure, the ESMA agreed with the CONSOB decision by considering, in particular, that the temporary ban would have minimized not only 'the risk of a loss of market confidence' in MPS's shares but also 'the risk of a contagion effect to other shares of the Italian banking sector'.⁶²

⁵⁶ *ibid.*

⁵⁷ See CONSOB Resolution n 18512 (2 April 2013) <<http://www.consob.it/mainen/documenti/english/resolutions/res18512.html>> accessed 30 July 2016.

⁵⁸ Marco Ferrando and Carlo Festa, 'US Hedge Funds Willing to Take a Closer Look at MPS Capital Increase' *ItalyEurope* 24, *Il Sole 24 Ore* (10 February 2014).

⁵⁹ See CONSOB Resolution n 18512 (15 April 2014) (short selling prohibition in MPS shares was in place from 15 April to 16 April 2014); CONSOB Resolution n 19008 (8 August 2014) (short selling prohibition in MPS shares was in place from 8 August to 11 August 2014); CONSOB Resolution n 19050 (16 October 2014) (short selling prohibition in MPS shares was in place from 16 October to 17 October 2014); CONSOB Resolution n 19052 (27 October 2014) (short selling prohibition in MPS shares was in place from 27 October to 28 October 2014).

⁶⁰ See CONSOB Resolution n 19053 (27 October 2014) and CONSOB Resolution n 19063 (11 November 2014).

⁶¹ See CONSOB Resolution n 19053 (27 October 2014) and CONSOB Resolution n 19063 (11 November 2014). See also Sam Fleming and others, 'Monte dei Paschi shares tumble 20%' *Financial Times* (27 October 2014) (reporting a 20% drop of the price of MPS as a consequence of the comprehensive review conducted by the European Central Bank).

⁶² ESMA, Opinion, 'Emergency measure by the Italian CONSOB under Section 1 of Chapter V of Regulation No 236/2012 on short selling and certain aspects of credit default swaps' (27 October 2014); ESMA, Opinion, 'Renewal of emergency measure by the Italian CONSOB under Section 1 of Chapter V of Regulation No 236/2012 on short selling and certain aspects of credit default swaps' (10 November 2014).

In January 2016, MPS once again became a target for short sellers: this time, CONSOB reacted by adopting three restrictions on short selling based on Article 23 of the SSR. The first prohibition was introduced on 11 January 2016, due to intraday volatility that caused MPS shares to decrease by more than 10 per cent in a single day.⁶³ The second prohibition was adopted on 18 January 2016, in consideration of the decrease in the new MPS stock again by more than 10% during that single day.⁶⁴ The third prohibition on 19 January 2016, extended the short selling prohibition until 21 January 2016,⁶⁵ because of the further decrease by more than 5% in the value of MPS shares.⁶⁶ Despite adopting these measures, MPS shares declined significantly from 18 January to 21 January.⁶⁷

As reported by the financial news,⁶⁸ the short positions on MPS shares taken by some hedge funds before the ban was adopted by CONSOB on 18 January 2016 were part of a broader distressed securities strategy that involved an attempt to acquire the non-performing loans held by MPS at the lowest possible price.⁶⁹ Putting downwards pressure on the price of MPS shares by short selling the bank's stock would have led to more favourable negotiations for the buyers (ie at a lower price) in the attempt to purchase the non-performing loans due to the bank's difficulties in the face of diminished market capitalization.

Achieving this goal was conditional on a decrease in MPS shares. At that time, MPS shares were already experiencing a significant decline that triggered the ban adopted on 18 January 2016. However, that ban did not impede speculators from pursuing their strategy, since they could put further downwards pressure on the price using put options.

Short selling and purchasing put options are both bearish strategies used to speculate on the potential decline in a security or index or to hedge downside risk in a long exposure portfolio or specific stock. In the MPS case, after the ban was introduced on 18 January 2016, short sellers took short positions by buying put options from market makers. By selling put options, the market makers took long positions on the underlying financial instruments, namely the MPS stock. To hedge these long positions, the market makers were forced to short the MPS stocks, as permitted by the market making

63 See CONSOB Resolution n 19484 (11 January 2016) (short selling prohibition in MPS shares was in place from 11 January to 12 January 2016).

64 See CONSOB Resolution n 19488 (18 January 2016) (short selling prohibition in MPS shares was in place from 18 January to 19 January 2016). As reported by financial news, on 18 January 2016, MPS stock dropped as much as 15%, triggering an investigation from the CONSOB, see <<http://www.reuters.com/article/idUSR1N13B01Q>>.

65 See CONSOB Resolution n 19489 (19 January 2016) (short selling prohibition in MPS shares was in place from 19 January to 21 January 2016).

66 The FCA acted in the same way, see FCA, 'Temporary Prohibition of Short Selling: Banca Monte dei Paschi di Siena S.p.A.' (18 January 2016) <<https://www.fca.org.uk/news/temporary-prohibition-of-short-selling-banca-monte-dei-paschi-di-siena-spa>> accessed 30 July 2016 and FCA, 'Extension of Temporary Prohibition of Short Selling: Banca Monte dei Paschi di Siena S.p.A.' (20 January 2016) <<https://www.fca.org.uk/news/extension-temporary-prohibition-of-short-selling-banca-monte-dei-paschi-di-siena>> accessed 30 July 2016.

67 See Gianluca Paolucci, 'Il crollo di Mps deciso a tavolino da tre fondi speculativi americani' *La Stampa* (22 January 2016) (hereinafter, 'Il crollo di MPS').

68 *ibid.* See also Gianluca Paolucci, 'La Consob indaga sul crollo Mps. E per il rischio ritorna la pista Santander' *La Stampa* (23 January 2016); Fabrizio Patti, 'Chi ha incastrato Monte dei Paschi' *LINKIESTA* (22 January 2016).

69 During those days, rumours were circulating regarding the likely decision by the Italian government to provide a public guarantee through the state-owned company, Cassa Depositi e Prestiti, for the non-performing loans held by MPS and other Italian banks. This speculation made the non-performing loans held by MPS more appealing, see Paolucci, *Il crollo di MPS* (n 67).

exemption introduced by CONSOB (when adopting the ban on 18 January 2016) pursuant to Article 23(3) of the SSR. The result of this hedging activity by the market makers was further downward pressure (despite the ban) on MPS stocks, which was expected by the hedge funds when they purchased put options from the market makers.⁷⁰

4. The market making exemption

In Section 2, we examined the regimes of ‘permanent’ restrictions and of ‘temporary’ measures that can be adopted by NCAs in ‘exceptional circumstances’ or ‘in the case of a significant fall in price’. Both regimes provide exemptions for the implement of short selling by market makers and authorized primary dealers.⁷¹ Therefore, only those firms that qualify as market makers (and only in connection with their market making activities) may benefit from such exemptions.⁷²

The exempting provisions of the SSR implement one of the IOSCO principles of 2009⁷³ and are consistent with the view expressed by the IMF⁷⁴ and the ECB.⁷⁵ In consideration of the need to balance the potential benefits of short selling and the potential risks associated with this type of trading strategy,⁷⁶ IOSCO emphasized that ‘[s]hort selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development’.⁷⁷ Among the activities to be exempted, IOSCO explicitly included bona fide hedging, market making, and arbitrage activities, based on the assumption that these activities do not affect the overall stability of the financial markets.⁷⁸

Under the SSR, the exemption does not automatically apply to market makers because they must notify the NCA regarding their intention to benefit from the exemption at least thirty days in advance and the NCA has the power to adopt a prohibition if the market

70 As noted by some financial news publications, during those days, not only did MPS shares decrease significantly in value but also the Italian spread increased on 19 January 2016 as a further consequence, see Paolucci, *Il crollo di MPS* (n 67). On the next day (Wednesday 20 January 2016), the Italian Treasury decided to provide a government guarantee to be assigned based on the needs of each banking institution, resulting in restored investor confidence throughout the banking sector, which was proven by the fact that MPS shares gained 43% during the same day of the intervention, see Paolucci, *Il crollo di MPS* (n 67).

71 See SSR, arts 17, 18, 20, 21 and 23. Art 16 of the SSR provides an exemption from certain permanent requirements for those shares of an issuer traded in the EU whose principal venue for trading is located in another country.

72 The exemptions do not apply to market makers that conduct proprietary trading, see SSR recitals 26. See the definition of ‘market making activities’ provided by art 2(1)(k) of the SSR (pursuant to the SSR, only those firms that provide liquidity by posting two-way quotes, that fulfil clients’ orders or that conduct hedging activities against the risk associated with the other activities qualify as market makers).

73 OICV-IOSCO, ‘Regulation of Short Selling’ (Final Report, 2009) <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD292.pdf>> accessed 30 July 2016 (hereinafter, ‘IOSCO Report 2009’). For a comment of IOSCO’s principles on short selling, see Roberta S Karmel, ‘IOSCO’s Response to the Financial Crisis’ (2012) 37 J Corp L 849, 876–83.

74 International Monetary Fund, ‘IMF Staff Comments on EU Commission Consultation on Short Selling’ (5 August 2010), 10 <<http://www.imf.org/external/np/eur/2010/pdf/080510.pdf>> accessed 30 July 2016.

75 ECB, ‘Commission Public Consultation on Short Selling—Eurosysteem Reply’ (5 August 2010), 6–8 <https://www.ecb.europa.eu/pub/pdf/other/eurosystems_reply_to_a_commission_public_consultation_on_short_selling.pdf?e1e8b96d00ac88b7695f3eebcb8e47b> accessed 30 July 2016 (hereinafter, ‘ECB Public Consultation’).

76 IOSCO Report 2009 (n 73) para 3.32.

77 IOSCO Report 2009 (n 73) 4th principle.

78 IOSCO Report 2009 (n 73) para 3.38. However, IOSCO (and earlier the ECB, see *ECB Public Consultation* (n 75)) stressed the importance to provide narrow and clear definitions of the general notions of ‘market making’, ‘hedging’ and ‘exempted activities’.

maker does not meet all the conditions.⁷⁹ However, this notification regime is related to the exemption from the 'permanent' requirements, although it is not specified whether the NCA must impose the obligation to notify to use the exemption associated with the 'temporary' restrictions adopted in 'exceptional circumstances' or 'in the case of a significant fall in price'.⁸⁰

Typically, market makers use the exemption when they must short a given stock for hedging purposes against the risk related to a put short position taken after the sale of a put option.⁸¹ Assuming a short position through options is allowed under the SSR.⁸² Therefore, a market maker that takes a short position in a put (which corresponds to a long position on the underlying stock) may need to hedge the position by short selling the underlying stock.⁸³ However, as we have discussed above, market makers may take short positions in a stock for hedging purposes when the risk to be hedged is related to their market making activities. Thus, a market maker may short stocks for hedging purposes when it sells a put option within its market making activity and not within its proprietary trading activity.

As also noted in the financial literature,⁸⁴ the short sale exemption granted to market makers for hedging purposes helps investors acquire short positions on the underlying stock by means of options. Indeed, without the exemption, market makers would be less willing to write puts,⁸⁵ and investors in turn would have less opportunity to bet against a specific stock by buying puts.⁸⁶

In the absence of a short selling ban, put options are commonly used as a bearish trading strategy alternative to short sales, particularly when borrowing costs are high.⁸⁷ In

79 See SSR, art 17(5) and (7).

80 See SSR, art 18(2), art 20(2), art 21(2) and art 23(3).

81 A short position in a put can be taken by buying a put.

82 See SSR, art 2(1)(b)(iii).

83 When a market maker sells (writes) a put (or takes a short put position), it will profit only if the underlying stock increases in value, while the investor that bought the put will make a profit if the underlying stock decreases in value. Therefore, to hedge the short put position, the market maker must short sell the stock underlying the put option to profit in the event of a decrease in the price of the stock, which offsets the loss booked for the sale of the put.

84 See Bruce D Grundy, Bryan Lim and Patrick Verwijmeren, 'Do Option Markets Undo Restrictions on Short-Sales: Evidence from the 2008 Short Sale Ban' 2010 WFA Meeting Paper, at 34–36 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1509726> (hereinafter, 'Do Option Markets Undo Restrictions') (the authors found that during the short selling ban in the USA from 19 September 2008, to 8 October 2008, option volumes decreased in relation to the stocks for which the ban was applied).

85 See Robert Battalio and Paul Schultz, 'Regulatory Uncertainty and Market Liquidity: The 2008 Short Sale Ban's Impact on Equity Option Markets' (2011) 66 J Finance 1213–20 and 2052 (hereinafter, 'Regulatory Uncertainty') (the authors explain that there was at first uncertainty among market makers regarding whether they were allowed to short sell stocks for hedging purposes after the introduction of the 2008 short selling ban in the USA. Due to this uncertainty, some market makers threatened to refrain from trading options).

86 See Grundy, Lim and Verwijmeren (n 84) 34–36.

87 See Benjamin M Blau and Chip Wade, 'A Comparison of Short Selling and Put Option Activity' (2009), <<http://ssrn.com/abstract=1348133>> 23–25 (the authors found, in particular, that when short selling activity is high and borrowing costs increase accordingly, then investors migrate to the option market to make bearish bets. Therefore, according to the authors, options reduce borrowing costs because they offer an alternative to short selling. Moreover, the authors concluded that short selling activity predicts negative returns better than put-option activity); see also Stephen Figlewski and Gwendolyn P Webb, 'Options, Short Sales, and Market Completeness' (1993) 48 J Finance 761 (the authors found that option trading permits the equivalent of short selling stocks in those cases in which investors are constrained from taking direct short positions); Robert Battalio and Paul Schultz, 'Options and the Bubble' (2006) 61 J Finance 2071–102 (the authors argue that short selling constraints were irrelevant during the internet bubble since investors could have shorted the stocks by means of options). On the use of derivatives for the purpose of

turn, when a ban is introduced, put options may be the only alternative for short sellers to bet against a stock, although data on the 2008 short selling ban in the USA show that no significant migration from short sales to put options occurred during that period.⁸⁸ However, this general trend does not negate the possibility that, in some specific circumstances, investors may use put options in lieu of short sales when a short sale ban is introduced to take short positions on a given stock.

Some studies in finance have proven that, when a short sale ban is in place, short positions taken by means of options and credit default swaps did not have an immediate decreasing effect on the price of the underlying stock, since it takes more time for negative information to be incorporated into stock prices.⁸⁹ However the MPS case shows that in some specific situations, this decreasing effect might become more immediate as a consequence of the short selling activity engaged in by market makers when hedging their put short position. In fact, if investors force the market maker who sold the put options to hedge its short put position by heavily short selling the stock, then the depressing effect on the price of the stock would allow the investor to profit by utilizing the short position taken by means of the put option.

In the MPS case, as reported in the financial news,⁹⁰ the hedge funds that in January 2016 bought put options may have forced the market makers from whom they bought the put options to hedge by short selling MPS stock. Therefore, this case shows that short selling activity conducted by market makers may have the (involuntary) effect of anticipating the depressing impact of short positions taken on the stock price by means of put options. Indeed, as already mentioned, when investors buy put options, it takes more time for the negative information to be incorporated into the stock price. However, this process of incorporation may be accelerated by the hedging activity engaged in by the market maker that directly short sells the stock in its traditional form. Therefore, in specific situations, the market making exemption, on one hand, may allow the market maker to short the stock for hedging purposes; on the other hand, however, it may permit investors (that took short positions by means of put options) to indirectly obtain a depressing effect on the stock price by means of the hedging activity implemented by the market makers.

During the financial crisis of 2008 in the USA, after the introduction (on 18 September) of a ban on both covered and naked short selling for 797 financial stocks (which was then renewed until 17 October), the Securities and Exchange Commission

circumventing short selling bans, see Tyler A O'Reilly, 'Reconstructing Short Selling Regulatory Regimes' (2013) 59 Wayne L Rev 53. However, according to some other studies, the introduction of options does not reduce the costs of short selling, see Stewart Mayhew and Vassil Mihov, 'Short Sale Constraints, Overvaluation, and the Introduction of Options' (2005) AFA 2005 Philadelphia Meetings <<http://ssrn.com/abstract=544245>>.

88 See Battalio and Schultz (n 85).

89 See Sophie Xiaoyan and Jun Pan, 'Trading Puts and CDS on Stocks with Short Sale Ban' (2011) <<http://ssrn.com/abstract=1572462>>. See also See Seraina Gruenewald, Alexander F Wagner and Rolf H Weber, 'Short Selling Regulation after the Financial Crisis—First Principles Revisited' (2010) 24–26 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439652> (describing the reasons that make it difficult to replicate short selling by means of options and futures strategies. Moreover, the authors stress that 'derivative trading does not have any direct influence on the price of the underlying').

90 See Paolucci, *Il crollo di MPS* (n 67).

(SEC) was aware of the risk that the ban might be circumvented by means of the market makers activity. For this reason, the SEC prohibited market makers from short selling the banned stocks for hedging purposes if the transaction would have permitted a customer or a counterparty to increase its net short position in the focal stock.⁹¹

Therefore, we need to consider if a similar provision can be adopted by European institutions for the goal to make more effective the temporary bans once adopted.

5. Policy considerations

As previously discussed in Section 2, the SSR provides the possibility for the NCA to apply exemptions for ‘market making activities’ and ‘primary market activities’, when adopting ‘temporary’ restrictions in ‘exceptional circumstances’ or ‘in the case of a significant fall in price’, which implicitly leaves discretionary powers to the NCA in deciding when the conditions are fitting for introducing the exemptions.

As emphasized in the context of the ECJ judgment in 270/12, discretionary powers are a main issue regarding the application of the SSR. In that case, the ECJ was called to decide whether the power (granted by Article 28 of the SSR to ESMA) to ‘prohibit or impose conditions on’ the execution of short selling was too broad and discretionary. In granting this power, Article 28 also authorizes ESMA to introduce exceptions for market makers and primary market dealers. Therefore, despite the ECJ decision to consider ESMA’s power under Article 28 as non-discretionary, however, ESMA is provided with discretionary powers when deciding to introduce exceptions for market makers and primary market dealers.

The power of NCAs to introduce exemptions for market makers and primary market dealers from the ‘temporary’ restrictions is also discretionary, whereas exemptions from the ‘permanent’ restrictions⁹² always apply to market makers as long as they are used within their market making activities.⁹³ However, exemptions from the ‘permanent’ requirements do not apply automatically, but only after the NCA has verified whether the market maker satisfies the imposed conditions for the use of the exemptions by means of a mechanism articulated as follows: the market maker notifies the NCA ‘in writing that it intends to make use of the exemption [...] not less than 30 calendar days before the [market maker] intends to use the exemption’.⁹⁴ Within the 30 days period, the NCA will

91 See Amendment to Emergency Order Pursuant to s 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No 34-58611 (21 September 2008) (hereinafter, ‘SEC Amendment to Emergency Order’) (‘if a customer or counterparty position in a derivative security based on a Covered Security is established after 12:01 a.m. E.D.T on September 22, 2008, a market maker may not effect a short sale in the Covered Security if the market maker knows that the customer’s or counterparty’s transaction will result in the customer or counterparty establishing or increasing an economic net short position (i.e., through actual positions, derivatives, or otherwise) in the issued share capital of a firm covered by this Order’).

92 The permanent requirements as above said consist in some transparency obligations of net short positions, in some conditions to be met for the executions of short sales in shares and sovereign debt, and in a general prohibition against uncovered sovereign credit default swaps.

93 See SSR, art 17(5).

94 See SSR, art 17(1).

evaluate whether the market maker's request satisfies the imposed conditions for the use of the exemption.

These conditions have been specified by the ESMA Guidelines regarding the market making exemptions under SSR.⁹⁵ The main condition is that the requested exemption refers to a short position instrumental to the market maker for hedging other positions.⁹⁶ The ESMA Guidelines further clarify that, to consider a short position as connected to the hedging activity of the market maker and thus approved for exemption, 'the size of the position acquired for the purpose of hedging should be proportionate to the size of the exposure hedged'.⁹⁷ In other words, as mentioned above, the short position must satisfy the condition of 'proportionality'. In addition, according to the ESMA Guidelines, the short position must also satisfy a temporal requirement in the sense that, as also specified in recital 26 of the SSR, the short position must be held for a 'brief period'.⁹⁸ We believe that the 'duration' requirement is strictly consequential to the 'proportionality' requirement: the short position (in a size proportionate to the size of the hedged long position) must be held as long as it serves to hedge the long positions. Since market makers generally hold their long positions for short periods, in this sense it is generally expected that the short positions will be held for short periods.⁹⁹

As to the exemption from the 'temporary' restrictions, we have highlighted above that the SSR allows the NCA to introduce a market maker exemption when adopting a 'temporary' ban on short selling in 'exceptional circumstances'¹⁰⁰ or 'in the case of a significant fall in price'.¹⁰¹ In this regard, the ESMA Guidelines clarify that the power of NCAs to introduce the exemption when adopting an 'emergency measure' is 'a discretionary power left to the authority introducing the measure'. Therefore, under the SSR, NCAs and the ESMA adopting the 'temporary' ban on short selling do not have to provide any specific reason in supporting their decision to introduce a market making exemption. However, the ESMA has also specified that 'when an exception applies to market making activities, the latter should be understood as defined in the Regulation'. This means that when the NCA introduces an exemption for market makers, the market makers may benefit from the exemption as long as they take short positions that satisfy the 'proportionality' and 'duration' requirements above discussed. However, from a procedural perspective, some relevant differences exist between the exemptive mechanism in the context of 'permanent' requirements and the exemptive mechanism in the context

95 See ESMA, Guidelines, 'Exemption for market making activities and primary market operations under Regulation (EU) 236/2012 of the European Parliament and the Council on short selling and certain aspects of Credit Default Swaps',—ESMA/2013/74 (hereinafter, 'ESMA Guidelines').

96 See *ESMA Guidelines* (n 98) 7, paras 23–25.

97 See, at 7, para 25, ESMA has specified that the market maker 'should be able to justify upon request from the competent authority why an exact match in size was not possible. The discrepancy should, in all cases, be insignificant'.

98 See *ESMA Guidelines* (n 98) 7, para 23; in recital 26 of the SSR it is used the expression 'very brief periods'.

99 See *ESMA Guidelines* (n 98) 8–9, paras 28–34, ESMA has further specified (para 28) that 'the exemption under Article 17(1) applies to activities in a financial instrument, i.e. on an instrument per instrument basis, and should not be considered as a global exemption for market making activities in general'.

100 See SSR, art 20(3).

101 See SSR, art 23(3).

of 'temporary' restrictions, indeed in the latter context, once the exemption is introduced by the NCA, market makers may use it without the need for a preventive notification.

Therefore, in the context of 'permanent' requirements we have a more bureaucratic mechanism, offering the advantage to allow a control of the use of the exemption. In the context of the 'temporary' requirements, the simpler mechanism may potentially cause a control deficit, which evokes two kinds of risks. First the market maker may use the exemption to take short positions not for hedging purposes within its market making activity, rather for 'proprietary trading' (therefore circumventing the ban with the purpose to benefit itself). Second, as the MPS case suggests, when the market maker (acting in bona fide) genuinely uses the exemption for hedging purpose it could involuntarily support a third party (an investor) in circumventing the ban. In sum, the market making exemption could potentially permit elusive uses of the market making exemption if the market maker uses it to implement proprietary trading strategies or in the context of a transaction that permits an investor to increase its short position after a ban on short selling was introduced.

The first issue, namely the use of the exemption for 'proprietary' trading by market maker, imposes inherent difficulties since it is actually difficult to prevent such conduct. Since the ban is usually adopted for short periods, it is difficult to design an *ex ante* mechanism of preventive notification. Therefore, the market maker that uses the exemption for proprietary trading should be treated as any regular investor breaching the 'temporary' ban and thus be subject to the same legal regime. The second issue may be solved by implementing the mechanism, above mentioned and hereby further discussed, adopted by the SEC in 2008.

We take the view that, when adopting 'emergency measures', the NCA should always introduce the exemption. First, this solution would be consistent with Article 17 of the SSR that permits market makers to use the exemption from the 'permanent' requirement as long as they comply with the 'proportionality' and 'duration' requirements, ie if they legitimately benefit from the exemption for hedging purposes in the context of their typical market making activity. Second, it is notorious that in some cases the market maker needs to hedge its positions by means of short selling to help investors hedge their positions, like for example in the case where the investor needs to hedge its long position by buying put options. However, it must be avoided that investors buy put options to circumvent the ban.

Indeed, the MPS case proves that the market making exemption may offer an opportunity for investors to circumvent the 'temporary' ban on short selling introduced 'in the case of a significant fall in price' (but also in 'exceptional circumstances').

As discussed above, in 2008 the SEC explicitly prohibited market makers from short selling banned stocks if such transactions would have had the circumventing effect of increasing the net short position of a customer or a counterparty in the stock. Beyond the debate regarding the opportunity to adopt temporary bans against short selling, it seems more coherent that NCAs, when conceding the market making exemption, specify that the short sale within the market making activity must not permit a customer or a counterparty to increase its net short position in a given stock to prevent a *de facto*

circumvention of the temporary ban. In this manner, it would be possible to ensure that the market making exemption is exclusively functional to the acquisition of short positions by investors for hedging purposes.

Unfortunately, data concerning the result of the application of this provision in the USA during the 2008 ban are not available. However, we take the view that in this case an assessment in terms of efficiency of the provision is not relevant. Rather, both the effectiveness of the ban (once adopted) and the prevention of the misuse of the exemption (once introduced) should be achieved.

As reported above, in the context of the 'temporary' ban on short selling adopted on 22 September 2008, the provision introduced by the SEC in relation to the market makers stated as follows: 'if a customer or counterparty position in a derivative security based on a Covered Security is established . . . a market maker may not effect a short sale in the Covered Security if the market maker knows that the customer's or counterparty's transaction will result in the customer or counterparty establishing or increasing an economic net short position (i.e., through actual positions, derivatives, or otherwise) in the issued share capital of a firm covered by this Order'.¹⁰²

However this provision seems to have a shortfall. Indeed, one could ask: how could a market maker know whether, by short selling a stock for hedging purposes in the context of a sale of a put option to an investor, it is facilitating such investor in its purpose of increasing its net short position, de facto circumventing the ban? One way for the market maker to come to know this fact is to request from the investor a statement declaring its positions in the focal stock (together with the corresponding sizes) before selling the put option to the investor. An investor who provides a false statement and has bought the put options for speculative purposes instead of hedging, misleading the market maker, should be treated as an investor who violated the 'temporary' ban. By means of the proposed statement, the market maker should be able to determine the net position of the investor, therefore refraining from entering transactions (like the sale of put options) that let the investor increase its net short position. Indeed, in this case the market maker would be prohibited from using the exemption from the 'temporary' ban on short selling to hedge its position resulting from the transaction.

Yet the importance of adopting specific mechanisms with the purpose to induce market makers to abide by the rule must not be underestimated. In the first place, it would be useful to promote, as a best practice, the market makers' request of the investors' statements about their positions in the focal stock, before entering into a transaction to sell put options in the presence of a 'temporary' ban on short selling. To this end, ESMA should support the establishment of the best practice by broadening its Guidelines representing this behavior as an example of diligent conduct by market makers. Ultimately, as an *extrema ratio* and after an appropriate cost-benefit analysis, NCAs may consider to impose (in the context of the adoption of a 'temporary' ban) an obligation for market makers to notify to the NCAs and the ESMA their use of the

102 See SEC Amendment to Emergency Order (n 91).

exemption—after the execution of a transaction (like the sale of put options) potentially instrumental to an elusive use by the investor—and the statement received by the investors. This type of ex post notification would certainly increase the general effect of ‘credible deterrence’ without hindering the ability to manage risk by means of immediate trading.¹⁰³

The considerations so far expressed can be safely extended to ESMA power to adopt market making exemptions pursuant to Article 28(1) of the SSR when intervening in ‘exceptional circumstances’. As noted above, this power has a discretionary nature. However, similarly to NCAs’ power to introduce exemptions in the context of a ‘temporary’ ban, we take the view that ESMA should always introduce the exemption, provided that the following conditions are fulfilled by the market maker using the exemption: (i) the exemption is used for hedging purposes, therefore the short position taken by the market maker meets the ‘proportionality’ and ‘duration’ requirement as above specified; (ii) the market maker does not use the exemption in the context of a transaction that would let an investor increase its net short position.

6. Conclusions

In this article, we examined the powers of NCAs and the ESMA to intervene in the context of ‘exceptional circumstances’ and ‘significant fall in price’ of listed shares. We sought to demonstrate that the ‘temporary’ ban on short selling adopted by the NCAs or the ESMA under the SSR can be circumvented by means of an indirect use of the market making exemption. As previously discussed, any evaluation of the effectiveness of the temporary ban on short selling as an instrument to restore investor confidence and to curb the volatility of stock prices explicitly falls beyond the scope of this article.

In the case of MPS, the circumvention of the ban by the hedge funds was implemented through a strategy that exploited the market making exemption. The hedge funds bought put options from a market maker, taking a long put position, ie, a short position on the underlying stock of MPS. By selling the put options, the market makers took a short put position and accordingly a long position on the underlying stock of MPS. In such a situation, the market maker was forced to short MPS stock with the intention of hedging the long position on the underlying stocks of MPS, substantially determining the circumvention of the ban by the hedge funds.

When adopting ‘temporary’ bans and conceding the market making exemption, we take the view that the NCAs and the ESMA should prohibit market makers from using the exemption in the context of a transaction that would let investors increase their net short positions in the focal stock. This requirement would have the effect of limiting the above described type of circumvention of the ‘temporary’ bans.

103 See OICV-IOSCO, ‘Credible Deterrence in the Enforcement of Securities Regulation’ (Final Report, 2015) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD490.pdf>> accessed 27 March 2017. IOSCO has defined deterrence as ‘credible when would-be wrongdoers perceive that the risks of engaging in misconduct outweigh the rewards and when non-compliant attitudes and behaviours are discouraged. Deterrence occurs when persons who are contemplating engaging in misconduct are dissuaded from doing so because they have an expectation of detection and that detection will be rigorously investigated, vigorously prosecuted and punished with robust and proportionate sanctions’.