AFM Market Watch

Newsletter on MAR, MiFID II and transaction reporting topics

September 2020, edition 1

Short selling during COVID-19

Editor's note

Dear reader, we are pleased to present the first edition of our recurring newsletter, the AFM Market Watch. It covers capital market related topics such as MAR, MiFID II and transaction reporting. The newsletter consists of two parts: (i) a lead article tackling a current capital market related topic, supported by data analyses; and (ii) a recurring short facts and figures section tracking developments in the market. The AFM Market Watch will be published on a regular basis and will be sent to subscriber (click here to subscribe).

In this first edition of the AFM Market Watch the topic 'Short selling during COVID-19' will be discussed (pp.1-5), followed by the facts and figures section (p.6).

Introduction

The global COVID-19 pandemic continues to affect financial markets globally. So far, a number of actions have been taken by National Competent Authorities ('NCAs') to address the effects of the pandemic. One subject that gets particular attention from all sides is short selling. The role of short selling in abnormal market circumstances can be controversial. The Dutch Authority for the Financial Markets ('AFM') has decided to dedicate its first Market Watch to the topic of short selling with a special focus on Dutch financial markets during COVID-19.

Sections 1-3 provide a more general analysis of short selling. Sections 4-8 short selling in the Netherlands is discussed with the use of data.

1. What does it mean to sell short?

To sell short is to engage in transactions in which financial instruments are sold on financial markets or over-the-counter by a seller who does not own the instruments. Short positions in shares are common, but short positions can also result from entering into contracts such as derivatives related to shares.

In the specific case of short selling in shares, shares are typically borrowed by the short seller from institutional investors with a more passive long-term investment strategy or from other investors –possibly through brokers– who are willing to lend their shares of a particular issuer for short periods of time. Lending plays a central role in short selling. Securities lending agreements typically require the short seller to put up collateral in the form of e.g. cash or other securities to cover the risk of the borrower not returning the financial instruments on the contractually agreed date. In this regard, uncovered short selling in shares has been restricted in Regulation (EU) No 236/2012 (‘SSR’).[1] With a so called buy-to-cover-transaction, the short position is eventually closed. Short positions in financial instruments related to shares technically follow the same principles. The potential added value of these short positions in instruments related to shares is that they do not always require securities lending for the short seller.

2. Why sell short, why can it be beneficial in general?

There are generally different reasons to take a short position. A short sell transaction is based on the expectation that the price or value of a particular stock, commodity, currency, other instrument or asset has reached its upside potential and is therefore likely to decline soon. The expected price decline is the profit potential of the short seller.

Short sellers can have different reasons to engage in this strategy. It is most commonly used for either hedging positions or, to a lesser degree, for speculation. The latter is less likely to occur due to the theoretical unlimited risk of loss as the stock price could continue to rise. Potential profits of short selling are capped by the stock price, but theoretical losses can –without a proper hedge with e.g. call options and/or bear put spread– be unlimited. Short sellers therefore presumably make calculated short decisions. A short position as a hedge aims to mitigate downside risks of a portfolio or specific stocks. Market makers and liquidity providers in exchange traded funds or other instruments often need to sell shares to hedge their downside risk.

Next to the role of short selling for individual market parties, short selling has benefits for the market. Short selling, first of all, contributes to markets in terms of liquidity. Short sellers are willing to sell at those moments when long holders of shares are not. More importantly, short sellers generally act on economic fundamentals thus contributing to price discovery and price efficiency. By doing so, short selling can foster stock price correction and consequently help to improve the functioning and efficiency of financial markets. For example, in the scenario that a stock price of a publicly listed company or issuer declines as a result of a profit warning by the issuer, this price decline is likely to be delayed because it takes time for conventional shareholders to correct their positions. Short sellers, however, are presumably better equipped than conventional long holders to predict potential price declines, as this is their business model. In this example active short selling in the issuer would contribute to a faster correction of the stock price of the issuer. Short selling could also contribute to markets by exposing overvalued[2] stocks. Short sellers can be considered effective company vetters, again as their business model requires them to be. They scrutinise financial reports, presentations and investor or analist meeting transcripts in search for red flags such as possible malpractices, changing alternative performance measures, growth figures and opaque business models. When short sellers discover serious discrepancies they essentially act as whistleblowers for the financial markets and could caution other investors and potentially obviate losses resulting from long-term (heavily) overvalued stocks.

3. What are some of the risks?

From a short seller’s perspective, the most significant risk of short selling is primarily caused by a miscalculation of the upside potential. Stock market prediction is therefore particularly important in the context of short selling. A miscalculation could result in substantial losses related to the rise of the stock price and possibily to unforeseen borrowing fees, margin calls and remittance of dividends received.

Short selling has a specific downside for the short seller as well, namely that of a so-called short squeeze. Short squeezes occur when a stock’s price rises to the point short sellers are forced to close out their

[1] See recitals 18 and 19 and article 12 SSR.

[2] ‘Overvalued’ or ‘undervalued’ stock sell above or below the liquidation or market value *the market* believes it deserves. Downes & Goodman 2018, *Dictionary of Finance and Investment Terms*, Hauppauge:Barron’s Educational Series, Inc.

positions, meaning buying back the shares. This could trigger a domino-effect where the stock price could actually rise exponentially in a short period of time, and early-in short sellers might be left with extreme heavy losses. What happens is that more shares are sold than actually currently available to buy back which results in a overvaluation of the stock. This is essentially detrimental to the short seller, the lender and the market in general. The short seller will have difficulty returning the borrowed shares with a penalty and as a result the short seller is forced to buy shares at market price to be able to close his position. The lender faces a default risk, lending to a short seller who cannot deliver back on the agreed returning date. And the functioning of the market will subsequently be affected due to volatility in an artificially overvalued stock and/or a possible reduction of liquidity (because of the risks for lenders).

From a market's perspective, there are two risks. First, a general –yet not inherent to short selling– risk of price manipulation. This risk would include a general decrease of stock prices due to the activity of short sellers. Second, uninhibited short selling in fragile and abnormal financial circumstances could help to trigger unusual volatility and substantial selling pressure, with possible price declines beyond economic fundamentals as a result.

4. COVID-19 pandemic

The debate around short selling has intensified during the (continuing) COVID-19 pandemic. The pandemic has had serious adverse effects on financial markets and the real economy across the EU. In this debate, short selling is not considered to be a cause of market uncertainty but rather a potentially destabilizing factor.

European Securities and Markets Authority ('ESMA') recently stated that the destabilizing effect of short selling is imminent in various financial markets in the EU.[3] As a reaction, two specific measures were taken to control short sell activity across European financial markets. Firstly, ESMA added a reporting threshold for short positions in shares larger than 0.1%. The aim of this temporary measure is to enable ESMA and NCAs to monitor any changes in short selling positions more effectively, thus providing a supervisory tool to help identify possible threats at an early stage. Figure 1 shows the average percentages of total / aggregated net short positions in AEX-issuers including the temporary 0.1% threshold and the 0.2% threshold for net short transactions. The time period in the chart starts in March 2020 briefly before the temporary threshold 0.1% entered into effect. The chart, first of all, shows that the 0.1% average is higher than the 0.2% average. This is due to the availability of more information on short selling, i.e. the short selling data from the notifications in the 0.1-0.2% bandwidth. More importantly, the temporary threshold of 0.1% provides more data points and therefore exposes changes in trends earlier. On the contrary, in some cases the 0.1% line actually shows a more flat line while the 0.2% line seems to show a change in trend. This can be seen in the beginning of April 2020. In the chart this is visible in the differences between both lines, which are more cogent in sector-specific analyses. This additional information improves the AFM's ability to monitor short selling positions.

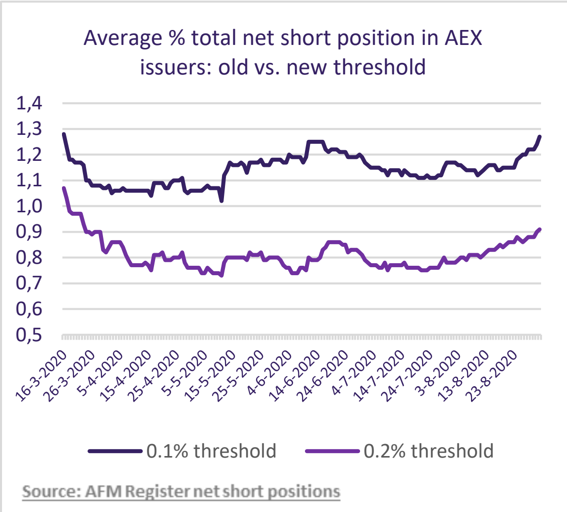


Figure 1

Secondly, a number of Member States have had temporary short selling bans, in some cases for specific instruments or markets. Pursuant to SSR, ESMA has issued a positive opinion on the (renewals of the) bans. Presently – September 2020 – the short selling bans are no longer in effect.

5. Short selling in the Netherlands

The registers of the AFM show that market participants take short positions in (Dutch) issuers on domestic financial markets.[4] The AFM is the NCA and relevant competent authority for various instruments for the purpose of SSR in the Netherlands.

The AFM recognizes the importance of short selling, as an available investment strategy, during normal market circumstances. However, the AFM has

[3] ESMA Decision, 10 june 2020, ESMA70-155-10189.
[4] Article 5 SSR net short positions are not disclosed. Article 6 SSR net short positions larger than 0.5% can be found in the AFM Register for net short positions. Gross short positions of larger than 3% can be found in the AFM Register substantial holdings and gross short positions.

consistently argued that in special market circumstances short selling can have a negative impact on the orderly functioning and stability of financial markets. This has occurred during the global credit crisis in 2008, when prices of financial issuers in the Netherlands were under pressure and responded heavily to negative information. These abnormal circumstances increased the risks associated with short selling. The AFM introduced the preventive temporary provision concerning Short Selling ('TRISS') which banned all types of short selling. TRISS was considered necessary due to clear signals of potential increases of short sell transactions in Dutch financial issuers, affecting financial stability.

6. The supervision of short selling

The AFM closely monitors developments, including short selling activities, in Dutch financial markets with the help of data-analysis. The AFM focuses on the market as a whole and on specific sectors, cross-examining aggregated individual and issuer specific data. The AFM examines the trading behavior of specific – often foreign – short sellers active on Dutch financial markets. This approach has helped the AFM to critically assess the necessity of restrictive measures such as a short selling ban in the Netherlands.

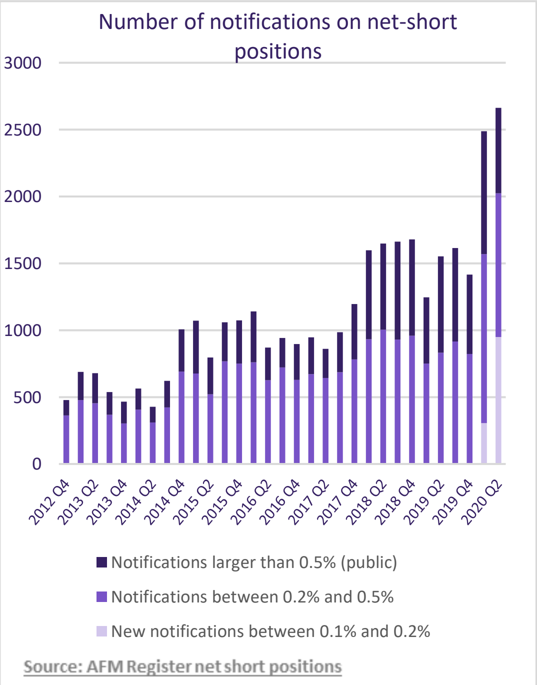


Figure 2

Next to data-based analyses, the AFM always stays in close contact with the relevant market participants. The AFM has received multiple requests to restrict short selling from issuers who raised concerns on the price forming process of their shares. All signals and concerns from market participants are carefully taken into consideration and actively used in and to improve supervision on short selling.

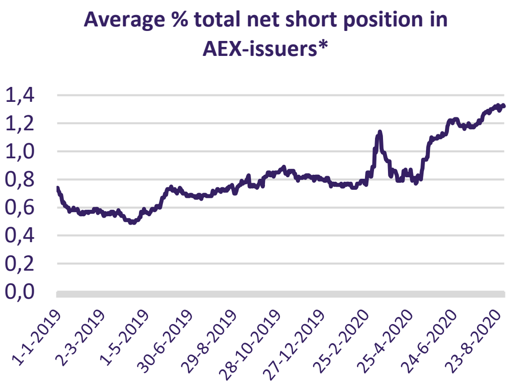
As a way to provide more information on the AFM's data analysis, Figure 2 shows the amount of net short data the AFM received since the SSR came into effect. This overview is particularly unique because normally only notifications larger than 0.5% are visible to the market. As seen in the figure, the bars in 2020 are higher. This is mainly caused by the inclusion of 0.1% net short notifications, and partly by the changes in the total placed capital of Just Eat Takeaway.com N.V. The latter has resulted in more net short notifications due to a dilution of the positions in the issuer. Q1 2020 shows a lower bar for 0.1% notifications because the measure entered into effect at the end of that quarter. What the figure does not show is whether the amount of 0.1% notifications is caused by the COVID-19 pandemic. In other words, if the temporary lower threshold of 0.1% entered into effect in 2019, it would be uncertain how high the amount of net short notifications would have risen.

7. Why was there no need to restrict short selling?

When to decide to restrict short selling, is not an easy question to answer in supervision. Article 20 of the SSR explains that a NCA may temporarily restrict short selling in case of adverse events or developments which either constitute a serious threat to financial stability or to market confidence. Furthermore, the measure must be necessary to address the threat and shall not have a detrimental effect on the efficiency of financial markets which is disproportionate to its benefits. It is an open norm and does not specifically describe which circumstances constitute a sufficient threat. ESMA points out that stock prices in ban-issuing Member States suffered value losses prior to these bans, e.g. main French indices lost up to or, in some cases, more than 30%. Moreover, ESMA underlines that apparent increase in the amount of net short positions under these adverse market circumstances could further exacerbate downward price spirals. According to ESMA, market integrity, the orderly functioning of financial markets and financial stability in ban-issuing Member States are therefore indeed at risk. More specifically, the justification of the bans is primarily the mixture of the volatile domestic market environment and the potential absence of accurate and reliable information to support the price formation mechanism.

The COVID-19 pandemic has an adverse effect on the real economy in the Netherlands. In light of the question whether it was necessary to restrict short selling in the Netherlands, it was first of all important to assess whether and in which way Dutch financial markets were affected by the crisis.

In its supervision, the AFM looks at multiple facets of the market. The starting point in this is the analyses performed on the net short positions received from market participants. Although the aggregated net short positions in the Netherlands at the time of the COVID-19 outbreak in Europe were elevated, these positions were gradually built up starting in the fall of 2019. In the direct aftermath of the COVID-19 related market crash, we have –apart from a few outliers due to reasons beyond COVID-19– experienced an apparent sharp decline in short selling positions towards previous levels, as seen in Figure 3.



Source: AFM register net short positions.
*unweighted average of total net-shortposition of AEX issuers, excl. RELX Plc & Just Eat Takeaway.com N.V., using the 0.2% notification threshold

Figure 3

In Q2/Q3 of 2020, there is a trend upwards in the total net short positions in AEX-issuers. As mentioned, the existence of adverse events or developments which constitute a serious threat to financial stability or market confidence is required to restrict short selling. While market confidence was down, this was primarily caused by the uncertainties following the COVID-19 pandemic. There are no objectifiable signals in regard to short selling indicating any form of market manipulation. In this regard, the AFM has not seen signs that short selling has contributed to a decline in market confidence. The AFM finds that financial markets in the Netherlands have been functioning well since the outbreak of COVID-19 and have responded to actual economic developments and expectations.

Short selling bans should not be imposed lightly, particularly in light of the fact that the SSR requires the possible ban to be a necessity to address the aforementioned threat. Therefore, the threat evidently has to be present.

8. Going forward?

The COVID-19-pandemic and its effects are still present. Financial markets in the EU have stabilized to a certain degree and have shown signs of normalization. Moreover, no short selling ban is in effect by the end of September 2020 in the EU. However, there is still uncertainty on financial markets as no viable vaccine is available. The risk for new waves of virus spreads is still apparent, with possible heightened uncertainty as a result. These circumstances might refuel a discussion about short selling bans.

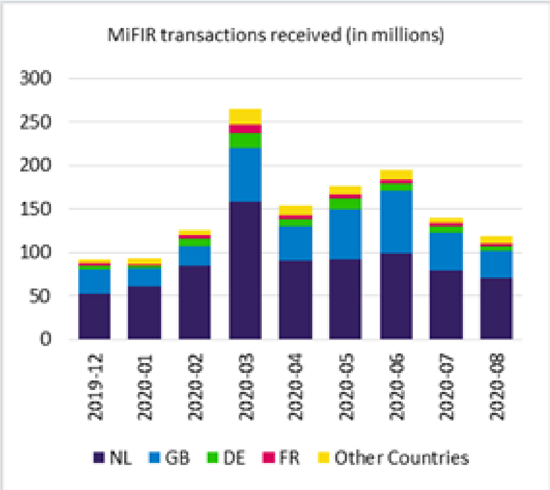
During COVID-19 NCAs in several Member States deemed it necessary to issue a short selling ban for their domestic financial markets, where this was not the case in the Netherlands. The AFM stays in close contact with other supervisory authorities and closely monitors changes on Dutch financial markets. The AFM underlines the importance of close cooperation between NCAs. Contact and cooperation with other NCAs might lead to new insights for the AFM.

A central objective of financial conduct supervision is to safeguard the fair and orderly functioning of financial markets. The supervision of short selling aims to contribute to this objective. Consequently, the AFM continues to carefully and closely monitor domestic financial markets and assess which possible intervention is necessary and appropriate in the light of the objective. A short selling ban, like other interventions, is an instrument that can be used when deemed necessary. In each case, it is paramount to examine which instrument or combination of instruments best safeguard the central objective of financial conduct supervision. How can intervention help to calm domestic financial markets and provide additional time to properly restore fundamental values? In addition, the AFM underlines the importance to take into account the specificities of the financial markets. Which short selling intervention will be necessary in the future evidently remains to be seen, but the AFM will continue to improve its insights and data-based supervision of short selling.

****

Facts & Figures

MiFIR transactions received by the AFM



Did you know:

- Our MiFIR Transaction Reporting team can be contacted by e-mail on TRS@afm.nl
- More information about Transaction Reporting can be found here.
- Current net short positions can be viewed here.

The graph represents the number of MiFIR art 26 transactions received by the AFM. These transactions, in millions per month, were sent by Dutch investment firms (NL) and by foreign NCAs to the AFM.

Autoriteit Financiële Markten (AFM)
The Dutch Authority for the Financial Markets
PO Box 11723 | 1001 GS Amsterdam

Telephone
020 797 2000
Fax
020 797 3800

www.afm.nl

Follow us: →

Mission statement:
The AFM is committed to promoting fair and transparent financial markets.
As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

If you are not on our email list yet, please subscribe on our website to receive future editions:
www.afm.nl/afmmarketwatch