

## Short Selling – The guidance materialises but uncertainty always remains



Peter Head, CCO of Cheyne Capital Management

**O**n Monday 23 July, both Spain and Italy introduced further restrictions on short selling. An impromptu decision perhaps, but it was only a matter of time before somebody pulled the regulatory trigger and restricted trading in this way; it is surprising that it didn't happen sooner.

As a hedge fund manager, we are bound by the terms of our investment management agreements and the guidelines and restrictions detailed in our Private Placement Memorandums. We must manage our funds in our clients' best interests and this is a requirement on which we are frequently tested by regulators. With this in mind, unexpected restrictions on trading during times of market dislocation can be problematic.

While we could look back on previous occasions when similar restrictions have been implemented and use the valuable guidance obtained at the time, uncertainty always remains. In this instance, the restrictions went

live with immediate effect, both were in force by lunchtime that day, but good quality guidance often takes days to materialise, if at all. Thankfully, we could rely on our previous experiences and the specialist advice already received – but this does beg the question of why these rules aren't made clearer in the first place.

As a case in point, the Spanish Regulator, the Comision Nacional del Mercado de Valores (CNMV) stated in its news release when implementing its recent restriction that "European securities markets are going through a period of extreme volatility which might cause their disorderly functioning... In these conditions it is necessary to review the operation of securities markets in order to ensure financial stability." Hedge fund managers would certainly agree with this statement.

So what can a hedge fund manager do to manage this volatility risk for its clients during these disorderly times? There are many financial tools

at our disposal (which I don't propose to discuss here), but a simple index hedge might help – I say a simple index hedge, but invariably nothing is ever simple.

Firstly, which index could you choose – the Ibex which was the index in focus for the CNMV's previous restrictions on short selling financial stocks, or perhaps the broader Eurostoxx index? There is no formal guidance as to which is deemed acceptable. Secondly, the CNMV guidance states that short positions in an index derivative are specifically included in the restriction. Therefore, it appears that hedging is not permitted. However, the guidance goes on to say that the CNMV accepts short positions where the index is being used to hedge general market risk, provided that the index creates only a "marginal" net short position in the banned stocks. There is no formal definition of marginal.

With directional trading using index derivatives prohibited and no formal definition of marginal available, can a hedge fund manager act in the best interests of its clients and hedge market volatility? With current guidance remaining unclear, we had better look back to the specialist advice we discreetly obtained when similar restrictions were in place and which now proves so valuable. ■

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