COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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REPORT

Technical details of the pan-European short selling disclosure regime

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Executive Summary

This report on the technical details of a pan-European short selling disclosure regime complements the Report on a Model for a Pan-European Short Selling Disclosure Regime (the Model) (CESR/10-088, the 'Report'). The two reports should be read in conjunction with each other and, collectively, contain CESR's proposal to the European Institutions for such a regime.

The technical details outlined in this report relate to the key areas identified in the Report for more in-depth explanation and elaboration. These key areas are subdivided into the following five sections: determination of economic exposure for the purposes of calculating a net short position; calculation of changes in a net short position; clarification of the level at which to net and aggregate short positions within an organisational structure; further development on the mechanics of disclosure; and a more detailed definition of the exemptions from disclosure obligations.

In parallel to making this proposal to the European Institutions, those CESR members that already have the powers to introduce a permanent disclosure regime will begin the process of implementing it; the others will aim at implementing such a regime on a best efforts basis. These additional technical details will assist the implementation of the Model by those CESR members who currently have the powers to implement it and will assist those members who do not currently have such powers in the development of a suitable legal framework for eventual implementation.

Introduction

1. On 2 March 2010, CESR published a Report (CESR/10-088) (the 'Report') and a Feedback Statement (CESR/10-089) on a Model for a Pan-European Short Selling Disclosure Regime (the Model). The Model recommended that an end-of-day net short position of 0.2% of an issuer's share capital should be disclosed privately to the relevant national regulator before the end of the trading day following the day on which the position was reached. At the higher threshold of 0.5%, positions should be disclosed both to the regulator and to the market. There should be end-of-day private disclosures for changes in net short positions (both up and down) above the 0.2% threshold at increments of 0.1%. A final private disclosure to the regulator as the net short position passes down through the 0.2% threshold would also be required.

2. The regime should only apply to issuers whose shares are admitted to trading on an EEA regulated market and/or an EEA MTF. However, the regime should not apply to shares admitted to trading on an EEA regulated market or an EEA MTF if their primary market is located outside the EEA.

3. As the Report represented a high-level description of the key elements of the Model, CESR acknowledged that there were certain areas in relation to which it needed to develop more technical and practical detail on the Model.

4. Accordingly, this report provides further detail on the following issues:

    1. Determination of economic exposure for the purposes of calculating a net short position;
    2. Calculating changes of net short position;
    3. Netting and aggregation within an organisational structure;
    4. The mechanics of disclosure; and
    5. Exemptions from disclosure obligations.

1. Determination of "economic exposure"

5. Net short positions, expressed as a percentage of the company's issued share capital should be calculated on the basis of financial instruments which create an economic exposure to the issued share capital of the issuer. A holder of economic interests in a particular issuer should net its long and short interests in that issuer in order to calculate its net short position. These calculations concerning disclosure obligations under the Model should be based on those positions held at the end of the day. Net short positions held intra-day would not have to be disclosed provided that the position held at the end of that day does not reach any of the disclosure thresholds (i.e. either the initial threshold or, in the case of a change of position, the incremental threshold).

A- Numerator

6. For this purpose, the net short position (numerator) should include any instrument (futures, equity swaps, contracts for differences, spread bets, options etc) giving rise to an exposure, whether direct or indirect, to the issued share capital of a company as well as a short sale in the cash markets. Any economic interest held as part of a basket, index or exchange traded fund (ETF) would need to be included when calculating the position in each individual share. This would also apply to trading in any derivative products relating to an index. While CESR recognises that such calculations might be complex, to exclude this type of instrument would make it easy to circumvent the regime and would thus render it ineffective. It would be possible to replicate a short position in a single share by shorting the basket/index and then obtaining long positions in the shares to which the seller did not want to be exposed.

7. As to guidance on calculating the net short position, any derivative and cash position would be accounted for on a delta adjusted, rather than a notional, basis (cash position having delta 1). In order to calculate the delta of a derivative, CESR would propose taking into account the current implied volatility of the derivative and the closing price of the underlying instrument. Therefore, in order to determine a position having equity investments and derivatives at the same time, CESR would propose calculating the individual delta adjusted position of every derivative that is held in the portfolio, plus or minus all cash positions. Persons entering into derivatives contracts giving rise to potentially disclosable short exposures should calculate net position changes in their portfolio arising from changes in the delta.

8. CESR considers that instruments that give entitlement to shares not in issue at the time the position is calculated (i.e. nil-paid rights, convertible bonds, equity warrants1) should not be taken into account to net off short positions. Therefore, in CESR's opinion, a person should not be able to net off a short position in the company's pre-existing share capital with a long position in the nil-paid rights. Similarly, nor should a prospective long position in the new shares, arising from an underwriting/sub-underwriting commitment, be netted off.

9. CESR recognises that there may be some limitations to this approach but believes, on balance, that it can be accepted for the sake of simplicity of calculation, ease of compliance and in order to achieve consistency with the determination of the issued share capital (denominator).

B- Denominator

10. The relevant figure for the calculation of net short positions is the entire issued share capital of the company (denominator), comprising ordinary shares and, if issued, preference shares but not any debt securities (including convertible bonds). Where issuers may have several share classes it would be necessary to take into account the total number of shares issued in each class and to add them up. CESR thinks other instruments giving entitlement to shares not in issue at the time the position is calculated should not be considered in this calculation as these instruments' interest may never be realised as an economic exposure to the share capital. In addition, there

[1] When issued by the issuer of the underlying.

would be compliance difficulties as participants would need to check existing share capital persistently.

2. Calculating changes of net short position

11. Calculating changes of net short position would be undertaken in the same way as described above, but it is worth making some observations by way of clarification.

12. If a person swapped an existing instrument that gave rise to a net short position with another type of instrument in the same issuer, an incremental disclosure would only have to be made if the swap takes the net short position into another reporting threshold. If there is no change, no disclosure would be required. So, if the financial instruments by which a position is achieved change but the net short position does not, a new disclosure does not have to be made (e.g. an existing derivative contract rolls over into a new derivative contract).

13. However, it is necessary to point out that delta changes of a portfolio or individual financial instrument, even though no additional short interest has been created, will trigger disclosure obligations whenever they take the net short position over another reporting threshold. CESR holds this view because the delta adjusted position is being taken as the main basis for calculation. Given that investment firms normally hedge at least on a daily basis, it will also be necessary to calculate net short positions on a daily basis.

14. Additionally, changes of short position may arise from changes in total issued share capital. Capital raising, bond conversion or capital amortisation can trigger or eliminate disclosure obligations. Persons entering into short positions should be able to calculate net position changes arising from whatsoever changes in issued share capital of this type. CESR considers that, for the purposes of the Model, a capital increase comes into effect when the new shares have been admitted to trading on a regulated market or a MTF.

3. Netting and aggregation within an organisational structure

15. At the outset, CESR believes that it is helpful to mention that the Model is intended to produce information that reflects the market impact of the short selling of shares as well as other transactions that enable investors to profit from a decline in the market price of the relevant share. CESR has stated that, in its view, the net economic short exposure, or net short position, is the type of measure most likely to reflect market impact.

16. For this reason, as already stated in CESR's Consultation Paper (Ref. CESR/09-581), CESR does not think that it would be appropriate to net off gross positions at group level, because in many cases that would result in the netting of positions taken in the context of completely different activities or strategies (e.g. long-term investments, short-term proprietary trading, investment management and so on). A figure calculated at group level would not reflect either the market impact of lower level short positions or the number of future share purchases needed to close out such positions. Additionally, it is necessary to ensure that holders of net short positions are not able to use a group structure to dilute their holdings and avoid compliance with the disclosure rule. For example, it would be inappropriate for a significant short position in a particular issuer held by one entity within a financial services group not to be disclosed simply because a long position in the same issuer was held by another, largely unconnected, entity in that group. Some kind of anti-avoidance measure is needed.

17. CESR's overriding principle in this context is that calculation and disclosure of net short positions should take place at the level of the person that is making the relevant investment decision. CESR's view is that legal entity level will often, but not always, be the appropriate proxy for this. However, a one size fits all approach based on netting at legal entity level will not always exactly capture the investment decision. So, while CESR stands by this overriding principle, it accepts that, given the complexities of many trading environments, there may be circumstances where it is necessary to net off positions at a different organisational level.

18. CESR believes that it is helpful to provide examples of netting methodologies to be used where more than one investment decision maker takes net short positions within a single legal entity.

19. A first example relates to funds (UCITS or non UCITS, whether in corporate or contractual form). In this context, CESR considers that, where different investment strategies are pursued in relation to a particular issuer's shares through separate funds, calculation and disclosure of net short positions should take place at the level of each fund. CESR believes that it is not appropriate to be able to offset positions in the different funds as these positions will represent different activities and strategies. Conversely, where the same investment strategy is pursued in relation to a particular issuer's shares through more than one fund, the positions in each of those funds should be aggregated for the purposes of disclosure.

20. A second example relates to the case of an entity such as a credit institution or investment firm with short positions being taken in more than one business line. In this case the net short position should be calculated for each separate business (which normally will be separated from the other businesses at least by information barriers). Therefore, where such an entity performs, for instance, both proprietary trading and individual portfolio management on a discretionary basis, the net short position as a result of proprietary trading should be aggregated across all relevant desks within the legal entity (this is likely to correspond to the entity's trading book), whereas the net short position in each discretionary management account would be subject to the requirement to report (also by the legal entity). As with the approach taken with funds, where two or more portfolios are managed on a discretionary basis pursuing the same investment strategy in relation to a particular issuer's shares in more than one of those portfolios, those positions should be aggregated and disclosed by the portfolio manager.

21. With respect to management of a client portfolio on a non-discretionary basis, the calculation of the net short position, as well as the disclosure requirement, would fall on the client. The client could ask the portfolio manager to conduct the calculation and make the disclosure on his/her behalf but, legally, the obligation remains with the client.

22. In providing this additional detail, CESR has striven to reach a balanced approach aiming at ensuring that the requirements for netting are both sufficiently sophisticated to capture investment decisions taken in a modern complex trading structure whilst sufficiently simple and clear as to be workable and enforceable.

4. The mechanics of disclosure

23. There are some key requirements for a disclosure mechanism that are common to private and public reporting. CESR believes that the mechanism for disclosure should be fast, secure, facilitate timely inputs and should not give rise to any legal or identification uncertainty. It should also be able to deal with the expected number of disclosures.

24. Regarding the short term, there are a number of potential options that achieve these requirements. The simplest is a 'manual' system, i.e. disclosure to the regulator by e-mail to a dedicated e-mail address or fax to a dedicated number. Public disclosure could be made in the same way, via the regulator and/or a national publication system (e.g. Regulatory Information Services (RIS) or a comparable national system). Manual reporting systems involve only minor cost implications for the investor and are also open to every private and professional investor. In the case of reporting by e-mail, it is important to ensure the integrity of the investor's identity. This might be achieved by using a digital signature or encryption mechanism, although CESR recognises that this may not be viable for all investors.

25. However, the size of the markets in some Member States means that it is likely that some regulators will receive a high number of private disclosures (from 0.2 up to 0.5%) and there may also be significant numbers of public disclosures (from 0.5%). High numbers of disclosures would have a significant impact on the resources of investors obliged to make disclosures and on the

regulators and other market participants seeking to monitor short selling by analysing the reports made. For this reason, CESR is of the view that manual disclosure alone, not augmented by some form of automated reporting, may not be practicable in all Member States.

26. In order to proceed with implementation in the short term, CESR's view is that the default position should be that competent authorities should allow some form of manual reporting. However, CESR recognises that Member States may wish to develop automated systems of reporting, at either or both thresholds, and, provided those systems are accessible to all those who will need to make disclosure reports and meet the requirements specified below, it would be open to Member States to operate only an automated system.

27. Any automated system has to meet the same principal requirements as a manual system, including ensuring the integrity of the investor's identity. CESR is aware of the potential resource implications of developing such a mechanism. However, while there will be a certain amount of start-up costs for investors, ongoing compliance costs may well be lower than with manual reporting, especially in those Member States where there are likely to be high numbers of disclosures. In addition, if the data is received by regulators in a way and through channels that allows for proper analysis there will be a discernible regulatory benefit justifying the cost of development. Again, it is likely that initial costs for building an automated system will be higher for regulators, but ongoing costs for analysis will be lower.

28. Concerning the design of an automated system there are a number of options Member States can choose from. One involves establishing a central repository for short position reports at a national level (i.e. competent authority). The manner of transfer of information to such repositories will depend on the number of expected reports. Therefore, by definition, this option would involve significant start-up costs. Start-up costs both for investors and the body responsible for running a repository would be lower for a manual based system, but the on-going costs of compliance and publication would probably be lower if the reporting was automated.

29. Regarding the long term, CESR has started analysing the possibility of harmonising further the mechanics of disclosure. In particular, CESR is investigating whether a central European repository and publication mechanism can be established, capitalising where possible on the TREM system.

5. Exemptions from disclosure obligations

30. In its Report, CESR stated its view that market makers should be exempted from any general disclosure regime based on individual short positions. This exemption is included because market makers play an important role in the financial markets through the provision of liquidity. This activity is vital to the efficient and effective running of markets. The exemption should only cover market makers when, in the particular circumstances of each transaction, they are genuinely acting in the capacity of a market maker. However, CESR would not expect market makers to hold significant short positions, other than for brief periods. CESR also notes that the term market maker is used in this context in a broad sense.

31. Accordingly, the following persons should be exempt from the disclosure obligations imposed by the Model:

32. An investment firm (or equivalent third-country entity), or a local[2] that is a member of a regulated market or an MTF (or equivalent third-country market), that deals as principal in the relevant share and/or related derivatives (whether OTC or exchange-traded), in either or both of the following capacities:

[2] The notion of local refers to the exemptions provided by article 2 (1) (d) and (I) in connection with articles 42(3) and 14(4) of MiFID.

i. by posting firm, simultaneous two-way quotations of comparable size and at competitive prices, with the result of providing liquidity on a regular and ongoing basis to the market;

ii. as part of its usual business, to fulfil orders initiated by clients or in response to clients' requests to trade, and to hedge positions arising out of those dealings.

33. CESR's view is that this exemption should apply to both private and public disclosure. Those conducting market making activities that wish to take advantage of the market maker exemption would need to make a prior notification to the relevant CESR member(s) of their intention to do so. This implies a change to the previous CESR view regarding the discretion of the Member States whether to require a notification on the use of the exemption.[3] The CESR member receiving such notification may decline to allow a party to make use of the exemption.

[3] See paragraph 54 of the Report (CESR/10-088).