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Hedge Fund Advisory

CESR reports on a pan-European short selling disclosure regime

On 26 May 2010, CESR published a report setting out the technical details of its proposed model for a pan-European short selling disclosure regime (the "technical details report"). The technical details report complements the earlier report published on 2 March 2010 (the "March report"), together with a letter to the European Commission and a *Feedback Statement*. The March report indicated that there were issues which required further, more detailed, explanation. The technical details report is the result. As CESR states, the two reports should be read in conjunction with each other and collectively they contain CESR's proposal for the new regime.

A reminder of the March report

What is the new regime in broad outline?

The regime remains based on a two-tier model of disclosures of short positions in shares that are admitted to trading on an EEA regulated market and/or an MTF. This would involve mandatory "private" disclosure to a relevant regulator of all short positions above a certain threshold and additional public disclosure to the market of larger, more significant short positions.

What holdings would be subject to the regime?

All short positions creating an economic exposure to any shares that are admitted to trading on an EEA regulated market and/or on an EEA MTF as their primary market.

Therefore, the regime would not apply to:

- positions creating an economic exposure to instruments which are not shares, such as bonds or MTNs;
- positions creating an economic exposure to shares which are admitted to trading on an EEA regulated market and/or EEA MTF *where the primary market for those shares is outside the EEA*.

So, what would the disclosure thresholds be?

The initial "trigger" thresholds would be as follows:

- Disclosure to the regulator: positions of **0.2%** or more.
- Public disclosure to the market: positions of **0.5%** or more.

In addition, further disclosures to the regulator and/or to the public would be required in respect of every **0.1%** change in a short position, whether upwards or downwards. Therefore, an increase in a short position from 0.3% to 0.4% would require an additional disclosure to the regulator (as would a decrease from 0.4% to 0.3%). An increase from 0.4% to 0.5% would obviously require an additional disclosure to the regulator but at the same time would also reach the initial trigger threshold for public disclosure thus requiring disclosure to the market too.

The technical details report

In outline, the technical details report addresses the following issues in more detail than the March report:

- *calculation of net short positions*: net short positions should be calculated on the basis of financial instruments which create an economic exposure to the issued share capital of the issuer. Long and short interests should be netted to calculate the net short position held at the end of the day. Net short positions held intra-day would not have to be disclosed provided the end-of-day position does not pass one of the disclosure thresholds. Note that the disclosure regime, both as to nominator and denominator, is focused on current issued share capital;

- *calculation of changes of net short position:* 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. However, if the financial instruments by which a position is reached change but the net short position itself does not, a new disclosure would not be required - the example CESR gives is that of an existing derivative contract rolling over into a new one;

- *netting and aggregation within an organisational structure:* the calculation and disclosure of net short positions within an organisational structure should take place at the level of the person making the relevant investment decision - CESR's view is that the legal entity will often, but not always, be the appropriate proxy for this. CESR provides a few examples:

  - In relation to UCITS or non-UCITS funds, CESR's view is 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 (and that it is not appropriate to allow offsetting of positions in the circumstances. The corollary is that, where the same investment strategy is pursued through more than one fund, the positions of each of those funds should be aggregated;

  - Where credit institutions and investment firms take short positions in more than one business line, the net short position should be calculated for each separate business. CESR gives the example of a firm which carries on proprietary trading as well as discretionary portfolio management: in this case, the net short position from the proprietary trading should be aggregated across all relevant desks in the firm, but the net short position in relation to each discretionary management account would be separately reportable. Where two or more discretionary portfolios are managed following the same investment strategy in relation to a particular issuer's shares, these positions should be aggregated and disclosed by the manager.

  - In relation to non-discretionary management, disclosure of the net short position would be the client's responsibility (although the manager may make the disclosure on the client's behalf).

- *the mechanics of disclosure:* in the short term, CESR recommend that competent authorities put in place a manual system of disclosure to the regulator (e.g. by e-mail to a dedicated e-mail address), or an automated reporting system (particularly where the size of the market means that a particular regulator is likely to receive a high number of disclosures). In the longer term, CESR is investigating the possibility of establishing a central European repository and publication mechanism.

- *exemptions from disclosure obligations*. CESR expands upon the market maker exemption referred to in its March report.

What does this mean for the FSA's short selling rules?

As we mentioned in our briefing on 27 April 2010 (Implementing the Financial Services Act 2010: Short Selling) the FSA now has new statutory powers to make short selling rules. It has consulted on exercising those powers to make short selling rules outside MAR, in a new Financial Stability and Market Confidence sourcebook (FINMAR). As currently consulted on, the regime will be substantially the same as the current one and no account is taken of the CESR pan-European regime at this stage - see CP10/11: Implementing aspects of the Financial Services Act 2010. The consultation period expires on 25 June 2010.

It remains to be seen when and how the FSA will look to implement the CESR recommendations. The following should be noted:

- CESR's report amounts to a proposal to the European Institutions (e.g. the European Parliament, the European Council and the European Commission) for a mandatory short selling regime in Europe. CESR recommends that there should be new European legislation on short selling, either by way of a new Directive or through amendments to the Transparency Directive.

- in sending the technical details report to the Commission, CESR reiterates in its covering letter the recommendation it made in its March report - i.e. that the European Institutions introduce a pan-European short selling disclosure regime as soon as possible. In the meantime, CESR has said that those of its members that already have the requisite powers to introduce the regime will start the process of doing so, while those members that do not have the necessary powers will seek to

- implement the regime on a "best efforts "basis. Clearly CESR is pressuring Member States to implement the two-tier disclosure regime quickly;
- we understand that the FSA is firmly of the view that consistency of international standards of the utmost importance as regards short selling requirements and that it would be counter-productive if different member states came up with regimes which differed in detail;
- we also believe that the European Parliament is in the process of putting together an own initiative report on short selling.

In the light of the above and given that the FSA's consultation on implementing a broad continuation of the existing UK short selling rules in a new FINMAR sourcebook remains open, it appears unlikely that the FSA will be looking to implement the CESR's "two-tier" regime immediately, although there is clearly some pressure to do so soon. Any proposal by the FSA to implement the CESR regime would have to be subject to a three month consultation process – we would not expect to see any such consultation emerging before the expiry of the existing consultation (CP10/11) and the implementation of the new FINMAR sourcebook.

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