

Financial Institutions Advisory and Financial Regulatory Group | March 15, 2010

## CESR Model for a Permanent Pan-European Short Selling Disclosure Regime

The Committee of European Securities Regulators ("CESR") has presented its report to the European Commission proposing a permanent pan-European short selling disclosure regime. The CESR report (the "Report") envisages a harmonised European approach to short selling. Since 2008, short selling has been subject to different actions taken by Member States in response to recent market turmoil. CESR's report, and the proposals it contains, seeks to avoid ongoing divergence in Member State requirements.

### Introduction

In July 2009 CESR launched a consultation on the need for a European disclosure regime for short selling to address the concern that, as a result of the patchwork of short selling regulations implemented in different states since 2008, market participants had become burdened with having to comply with divergent sets of national requirements. The Report, entitled "Model for a Pan-European Short Selling Disclosure Regime",<sup>1</sup> is the result of that consultation and recommends new European legislation on short selling to be enacted as soon as possible.

This memorandum summarises the proposals in CESR's Report for a pan-European short selling disclosure regime.

Details of the *ad hoc* measures taken on short selling in key jurisdictions are covered in our client note which provides an overview of global short selling restrictions, the latest update of which was published on 12 February 2010.<sup>2</sup>

<sup>1</sup> The Report is available at [http://www.cesr-eu.org/index.php?page=home\\_details&id=465](http://www.cesr-eu.org/index.php?page=home_details&id=465).

<sup>2</sup> "Global Clampdown on Short Selling: an Overview (v6)" available at <http://www.shearman.com/global-clampdown-on-short-selling-an-overview-v6-02-12-2010/>.

### Implementation

Pending EU legislative change, CESR members have agreed to begin the process of implementing the disclosure regime set out in the Report, either using their existing powers to do so or on a best efforts basis if the necessary legal powers do not yet exist. Therefore, although the Report is only a first step towards European legislation in this area, many European countries are expected to implement the proposed regime to the extent that they can until an official European regime is adopted.

On 4 March 2010 BaFin, the German Federal Financial Supervisory Authority, issued a General Decree, based on the CESR Report, which requires market participants to disclose to the regulator net short selling positions in shares of any of 10 selected financial institutions.<sup>3</sup>

The UK FSA proposed a permanent regime in a May 2009 consultation paper which would be applicable to all stocks and their related instruments. An initial threshold of 0.5% was proposed with additional disclosure required for increments of 0.1% thereafter. Following that consultation the FSA stated in October 2009 that it would maintain its current requirements

<sup>3</sup> Full details of the General Decree are available at [http://www.bafin.de/clin\\_171/EN/Home/homepage\\_\\_node.html?\\_\\_nnn=true](http://www.bafin.de/clin_171/EN/Home/homepage__node.html?__nnn=true).

and work with CESR to find an agreed European-wide disclosure regime for short selling. The FSA has yet to publish any response to the CESR Report.

Prior to the CESR Report a number of EU Member States took emergency action imposing restrictions on short selling and requiring disclosure of short positions above differing thresholds. For example, in the UK, the FSA currently requires disclosure to the market of net short positions of 0.25% or more of the issued share capital of UK financial sector companies or companies carrying out a rights issue. Additional disclosure is required if a short position changes by a further 0.1% of issued share capital (i.e. at 0.35%, 0.45% and so on).

In September 2008 the Autorité des Marchés Financiers (the "AMF"), the French regulator, banned short sales of stocks in selected financial institutions and required public disclosure of net short positions in those stocks which reached a threshold of 0.25%. The AMF announced in January 2010 that these measures would continue pending a permanent European-wide regime. In September 2008 the Irish regulator introduced a prohibition on the short selling of shares of Irish publicly quoted banks and required public disclosure of short positions reaching a threshold of 0.25%. The Irish regulator has not removed any of these provisions and is keeping the situation under review. By contrast, BaFin announced in January 2010 that its ban of uncovered short sales in 11 stocks would expire at the end of 31 January 2010.

The proposals in the CESR Report cover disclosure only. It is not proposed that additional measures taken by Member States, such as prohibitions on short selling, should be discontinued. CESR is continuing to consider whether further harmonised measures for the regulation of short selling are required. If Member States continue to impose divergent short selling restrictions, the risk of regulatory arbitrage remains.

CESR's view is that the disclosure regime should be implemented through either a new directive or regulation rather than through amendments to the Transparency Directive. The Transparency Directive contains a long position regime and the number of divergences from that regime in the proposed short selling disclosure regime makes, in CESR's opinion, a

new legislative instrument preferable. Furthermore, the Transparency Directive does not require full harmonisation. The decision as to how these new laws will be implemented rests with the European Commission. It is to be hoped that the Commission will opt for an implementation process which results in maximum harmonisation so as to eliminate the opportunity for regulatory arbitrage in this field.

## Scope

The permanent disclosure regime would apply to any short position creating an economic exposure to shares of EEA issuers that are admitted to trading on a European Economic Area ("EEA")<sup>4</sup> regulated market and/or an EEA multilateral trading facility ("MTF").<sup>5</sup> The regime would not apply to shares admitted to trading on an EEA regulated market and/or EEA MTF if their primary market is located outside the EEA. Other types of securities such as bonds would also be excluded from the regime.

These provisions would widen the scope of some of the current short selling measures implemented in Europe. For example, the German, French and Irish regulators have limited the disclosure to select financial institutions. In addition, the FSA regime only applies to the shares of a UK financial sector company or to a company carrying out a rights issue.

CESR considers that the regime should not be limited by sector or by the nature of the security for three reasons: (a) the risks posed by short selling are not confined to the financial sector and it is impossible to predict how the next crisis might develop or which sector might become vulnerable to abusive short selling; (b) limiting the regime to one sector would risk 'displacement' of the problems to other market areas; and (c) there is no reason to limit the benefits of such a regime to any one sector.

<sup>4</sup> The EEA includes all 27 Member States of the European Union and Iceland, Liechtenstein and Norway.

<sup>5</sup> Regulated markets and MTFs are trading venues so designated by Member States under the EU Markets in Financial Instruments Directive. A list of EEA regulated markets and MTFs is maintained by CESR and is available at <http://mifiddatabase.cesr.eu/>.

## Net short positions

In the proposed new legislation, it is envisaged that the reporting of short positions would be made on a net basis. As a result, long positions would be off-set against short positions in the same stock to determine if a disclosure obligation applies. For these purposes, account would be taken of transactions in all financial instruments that create an economic exposure to the shares of the issuer. Positions that may be netted would not be limited to positions in the cash equity markets but would also include positions in linked derivative contracts (exchange-traded or OTC), indices, baskets and exchange traded funds.

## Two-tier Disclosure

The Report proposes a two-tier disclosure system that would be applicable to all EEA jurisdictions. Once a net short position, expressed as a percentage of the company's issued share capital, reaches a specified first trigger threshold of 0.2%, disclosure to the relevant regulator would be required. CESR had suggested a threshold of 0.1% in its consultation but following feedback this limit was raised. Increments of 0.1% thereafter would trigger further disclosure to the regulator. If the net short position reached a second higher threshold of 0.5%, disclosure to both the public and the regulator would be required and any additional increment of 0.1% thereafter would also trigger both such disclosure obligations. Disclosures would again be required when the short position fell back below any of the trigger thresholds, including the initial thresholds. These thresholds would apply irrespective of whether a company is engaged in a rights issue.

There are arguments that public disclosure of significant short positions could deter short selling and damage fair markets because of the risk that short squeezes could be exacerbated by disclosures.

However, CESR concluded that the empirical analysis of such regimes already used by some Member States had not supported these concerns. Furthermore, CESR consider that there are substantial informational benefits for the market from public disclosure and the constraints it places on aggressive, large-scale short

selling. The latter may involve unacceptable risks of abuse or disorderly markets.

AIMA (the Alternative Investment Management Association) has criticised the proposed thresholds stating that they are too low, resulting in an excessive regulatory burden on some hedge fund managers and a deluge of unnecessary information for regulators and market participants. AIMA argues that only aggregate data should be disclosed to the market in order to prevent market distortions. The CESR Report proposes that Member States should have the option to publish aggregated data that regulators receive through private disclosure. CESR noted in its letter to the European Commission accompanying the Report that the AMF considered that the publication of aggregated data should be mandatory.

## Timing and Content of Disclosure

Disclosure would be required at a specified time before the end of the trading day following the day on which the disclosure obligation is triggered. Intra-day positions that cross a disclosure threshold but which return below the threshold before the end of the trading day would not be subject to a disclosure requirement.

CESR considers that 'maximum harmonisation' is required as regards the contents of disclosures. This means that disclosures would be in a uniform format and of identical content throughout Europe. Required disclosures would comprise: (a) the identity of the short position holder; (b) the identity of the issuer; (c) the size of the position held; and (d) the date on which the position was created or threshold was crossed, or the date on which the position was no longer held, if applicable.

## Market-maker Exemption

Market-makers would be exempt from both the private and public disclosure requirements based on individual short positions. CESR has indicated that the exemption would only apply to market-makers who are genuinely acting in the capacity of market-maker and that proprietary trading would not of itself be exempt.

In addition, CESR proposes that regulators should have the option to require financial institutions which intend to rely on this exemption to notify the regulator that they intend to do so.

require disclosure from entities that are not regulated by them.

## Legal Basis

The new disclosure regime would apply to unregulated entities as well as to regulated financial institutions.

Regulators would therefore need to be given powers to

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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