

Consultation Response to the CESR Proposal for a Pan-European Short Selling Disclosure Regime

Introduction

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Over 50 managers from the UK and abroad – totalling over USD 200BN in assets under management - have already committed to the process of the HFSB, and more are expected to sign up to the Standards over coming months. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. It is important that policy leaders trust that the HFSB will implement this market based regime with the industry and encourage adoption as well.

Short selling plays an important role in global financial markets and brings many benefits to the global economies, including investor protection against market volatility, increased liquidity for all market participants, more efficient price discovery, dampening of price bubbles and prevention of other market inefficiencies, and ultimately more efficient capital allocation. The ability to sell stocks short makes investing far more attractive at times of stress because it encourages investors to stay in the market even when prices are declining. By hedging their positions through short sales, investors can continue to hold other stocks with the aim of achieving absolute returns. Without the option to short sell, investors are much more likely to withdraw from a declining market, accentuating the market contraction during major crises like the present one. The recent short selling ban has brought this investment management and hedging instrument to the forefront of the public and regulatory debate.

The HFSB has in the past participated in various other consultations on short selling, notably:

- Committee of European Securities Regulators (CESR) call for evidence on regulation on short selling (01/2009)
- IOSCO Consultation on Regulation of Short Selling (05/2009)
- FSA Consultation on Short Selling (05/2009)

The HFSB is pleased to have the opportunity to respond to the CESR consultation paper, “CESR Proposal for a Pan-European Short Selling Disclosure Regime” (CESR/09-581).¹

Consultation responses

Q1 Do you agree that enhanced transparency of short selling should be pursued?

CESR lists several areas where it considers that the benefits of more short selling transparency outweigh the cost:

- Detecting market abuse
- Reducing risk of disorderly markets
- Information provision to assist price discovery

HFSB has a differentiated view on transparency of short selling. The subsequent paragraphs provide an assessment of each of the areas highlighted by CESR in more detail.

Detecting market abuse

CESR considers that improving the transparency of short selling would help to deter market abuse. HFSB agrees that regulators need to have tools to assess and monitor issues in relation to this, but it is important to highlight that no public disclosure requirement arises from this. It is only the regulator who might have additional information needs (or access to information, if needed).

HFSB would like to highlight that any potential negative impacts need to be assessed, including loss in market efficiency (a. discouraging information acquisition, b. encouraging herding) if disclosures are intended to be public.

Reducing risk of disorderly markets

It does not appear that there is a permanent threat to disorderly markets in relation to short selling at all. Indeed, the crisis in fall 2008 has not been caused by short selling. Therefore, it is difficult to build a case for a permanent reporting/transparency regime in relation to short positions.

However, regulators should be in a position to collect relevant data during times of distress. The focus should then lie on systemically relevant sectors (such as banking, insurance) and aggregate data. Obviously, this data is only relevant to the regulators (similarly to market abuse detection) and there is no case for public disclosure.

Information provision to assist price discovery

CESR mentions among the benefits of enhanced transparency that short selling conveys important information (eg that a stock is overvalued) to the market to assist price discovery. Along those lines, one could equally argue that on every short sale, there is a buyer, equally conveying important information to the market (eg that the stock is undervalued). Therefore, the “net signal” is actually not indicative at all of whether the stock is over or undervalued. In addition, short selling is used in

¹ http://www.cesr-eu.org/index.php?page=consultation_details&id=142

hedge transactions, where only the relative directional movement of a shorted stock matters (in relation to the respective long position), irrespective of whether the market rises or falls.

Therefore, HFSB would argue that all information is reflected in today's market price, irrespective of whether short selling has occurred or not. The aggregate impact of short selling might have reduced that price, but thereby this information is included in today's market price.

Portraying that short selling activity is a signal to other investors that a stock is overvalued is only true under the assumption that the parties short selling the stock have better information than those buying the stock. If some investors assume that mostly hedge fund managers engage in short selling and that hedge fund managers have better information, then they might give more weight to the fact that short selling occurs (rather than just assuming that today's price is the best estimate of future value).

The problem arises if regulators now argue that short selling can convey a signal, because they implicitly tell market participants that short sellers indeed have better information, and thereby encourage herding behaviour based on short selling disclosures. HFSB believes that it would be an arbitrary decision to enhance disclosure on the grounds of "additional valuable information" and that this might lead to market distortions/less efficient price discovery.

In summary, there is no case for further disclosure on the grounds of "informational benefits" or "assisting price discovery".

HFSB would recommend that CESR adopts a rigorous framework approach to assess the transparency needs in relation to short selling. HFSB has devised such a framework in its response to the UK FSA short selling consultation (p. 5 – 9).²

Q2 Do you agree with CESR's analysis of the pros and cons of flagging short sales versus short position reporting?

HFSB agrees that the first option, a short sale flagging regime, would be both operationally difficult and expensive for both brokers and trading platforms, ultimately raising trading costs for all investors.

HFSB also agrees that the second option, involving a requirement to report individual significant short positions to the regulator, is preferable. However, HFSB has doubts whether a regime with permanent disclosures to the regulator is required.

CESR argues that public disclosure of short selling data of individual parties might act as a potential constraint on "aggressive large scale short selling". It is indeed true that public disclosure alters the risk-reward ratio for short sellers (eg reduction of the price correction benefit) and discourages information acquisition (research) by market participants since this information would then be shared with the public. HFSB questions whether this is a desirable outcome in the first place, and believes that it would be an arbitrary decision to request public disclosure on the grounds of constraining "aggressive short selling".

² Public comment on FSA's Discussion Paper on Short Selling (DP09/1) by the Hedge Fund Standards Board (HFSB): [http://www.hfsb.org/sites/10109/files/public_comment_on_fsa_short_selling_consultation_\(final\).pdf](http://www.hfsb.org/sites/10109/files/public_comment_on_fsa_short_selling_consultation_(final).pdf)

Information acquisition by market participants is a positive, and whether it translates into (“aggressive”) buying, selling, or short selling, it contributes in all instances to efficient price discovery and better capital allocation. As mentioned above, issues in relation to market abuse need to be addressed via disclosure to regulators, but are not a matter of public disclosure.

Q3 Do you agree that, on balance, transparency is better achieved through a short position disclosure regime rather than through a ‘flagging’ requirement?

Yes.

Q4 Do you have any comments on CESR’s proposals as regards the scope of the disclosure regime?

CESR refers to the risks of short selling (27.) and highlights abusive short selling and disorderly markets. HFSB has no evidence for abusive short selling, or disorderly markets caused by short selling during the crisis in 2008.

As indicated by CESR, the temporary measures (ie disclosure requirements) applied only to financial sector stocks and led to displacement of the problems to other areas of the market. HFSB finds it important to highlight in this context that it was the actual measures (short selling restrictions, disclosure) that led to the displacement in the market place, not short selling.

CESR raises the question whether short selling disclosure should be restricted to particular market segments (eg financial services), or to the entire market and argues that in the next “crisis”, a different sector might become vulnerable. HFSB generally agrees that regulators should be able to access information to detect market abuse or disorderly markets in any market segment, not only financial stock. However, as argued above, it is important to highlight that there is no case for a dedicated public short selling disclosure regime (neither in financial stock, nor any other segment of the market).

Q5 Do you agree with the two tier disclosure model CESR is proposing? If you do not support this model, please explain why you do not and what alternative(s) you would suggest. For example, should regulators be required to make some form of anonymised public disclosure based on the information they receive as a result of the first trigger threshold (these disclosures would be in addition to public disclosures of individual short positions at the higher threshold)?

The following paragraphs provide HFSB’s view on the different features of the CESR proposal.

Positions exceeding the first disclosure threshold need to be disclosed to the relevant regulator: To determine whether a permanent disclosure regime for short positions (exceeding a certain threshold) to the regulator is required, an assessment of the threat/risk/cost of disorderly markets and market abuse is required. In the past, HFSB has argued that a flexible approach is sufficient, requiring disclosure to the regulators only in times of distress, as well the possibility for regulators to ask for ex post disclosures to investigate potential cases of market abuse. HFSB believes, that in general, regulators should indeed have access to all relevant information to assess disorderly markets and market abuse, however, we have not seen any evidence, suggesting that a permanent disclosure regime provides additional benefit over a more flexible ad hoc approach.

In relation to the second threshold for public disclosure, HFSB has already highlighted that such a disclosure regime would be arbitrary and would not improve price discovery (as highlighted in our answer to Q1, *Information provision to assist price discovery*). HFSB agrees with CESR's observations on "herding" effects, the risk of short squeezes, and HFSB would add the concern that public disclosure dis-encourages information acquisition by market participants.

Regarding an "anonymised" disclosure by the regulator based on the information regulators collect in the context of the first threshold, HFSB is concerned that the regulator is thereby implicitly suggesting that short selling data can convey a signal thereby encourage herding. HFSB believes that it would be an arbitrary decision to enhance disclosure on the grounds of "additional valuable information" and that this might lead to market distortions/less efficient price discovery.

HFSB suggests that more research is initiated in the area of public disclosure, to ensure any future disclosure regime has a solid foundation and to minimise its potential detrimental effects.

Q6 Do you agree that uniform pan-European disclosure thresholds should be set for both public and private disclosure? If not, what alternatives would you suggest and why?

The HFSB agrees that there should be a uniform regime for private disclosures to the regulator.

Q7 Do you agree with the thresholds for public and private disclosure proposed by CESR? If not, what alternatives would you suggest and why?

In relation to private disclosure, HFSB believes that a permanent threshold of 0.10% would generate a significant amount of ongoing disclosures, and is therefore too low. Here, HFSB believes that it is more suitable to have a more flexible ad hoc approach, allowing regulators to request information when concerns in relation to market abuse/disorderly markets arise. This will also contribute to more efficient allocation of regulatory resources.

In relation to public disclosure, HFSB would continue to argue that there is no case for a public disclosure regime on the grounds of market abuse/disorderly markets.

However, there is a case to require public disclosures of short sales mirroring the long disclosure regime (ie the Transparency Directive) in a symmetric manner. While CESR is right in arguing that the long disclosure requirements are not meant to address issues in relation to market abuse/disorderly markets, HFSB would like to highlight that such disclosures would be only be on the grounds of control. The reason why a symmetric approach to longs and shorts (at the same threshold) is warranted is because an owner can offset a large (gross) long position by simultaneously shorting the stock. Thereby, while voting rights remain with that party, it is not anymore economically exposed to the outcome of the exercise of its voting rights (if the long position is exactly matched by a short).

Finally, HFSB agrees that future fine-tuning of any short selling disclosure regime might be needed.

Q8 Do you agree that more stringent public disclosure requirements should be applied in cases where companies are undertaking significant capital raisings through share issues?

HFSB agrees that vulnerabilities can arise in the context of capital raising through share issues. Here again, disclosures are relevant to the regulators (to detect cases of market abuse), but not the general public.

Q9 If so, do you agree that the trigger threshold for public disclosures in such circumstances should be 0.25%?

No (as per assessment in Q1 and Q7 above).

Q10 Do you believe that there are other circumstances in which more stringent standards should apply and, if so, what standards and in what other circumstances?

No.

Q11 Do you have any comments on CESR's proposals concerning how short positions should be calculated? Should CESR consider any alternative method of calculation?

CESR proposes reporting of net positions, including derivative contracts and CFDs.

As highlighted and detailed in previous consultation responses³ HFSB agrees with a net position reporting for market abuse purposes to the regulator.

HFSB agrees that derivative positions should be included in calculating the position.

HFSB has also indicated that it would favour a symmetric regime in relation to control issues.

Q12 Do you have any comments on CESR's proposals for the mechanics of the private and public disclosure?

No.

Q13 Do you consider that the content of the disclosures should include more details? If yes, please indicate what details (e.g. a breakdown between the physical and synthetic elements of a position).

No.

Q14 Do you have any comments on CESR's proposals concerning the timeframe for disclosures?

No.

Q15 Do you agree, as a matter of principle, that market makers should be exempt from disclosure obligations in respect of their market making activities?

Yes.

Q16 If so, should they be exempt from disclosure to the regulator?

³ Response to FSA DP09/1:

[http://www.hfsb.org/sites/10109/files/public_comment_on_fsa_short_selling_consultation_\(final\).pdf](http://www.hfsb.org/sites/10109/files/public_comment_on_fsa_short_selling_consultation_(final).pdf), p. 8

Again, as highlighted before, regulators should be in a position to investigate the dealing of market makers (ex post) where concerns in relation to market abuse and disorderly markets have arisen. However, no permanent private disclosure to the regulators is required.

Q17 Should CESR consider any other exemptions?

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Q18 Do you agree that EEA securities regulators should be given explicit, stand-alone powers to require disclosure in respect of short selling? If so, do you agree that these powers should stem from European legislation, in the form of a new Directive or Regulation?

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