COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CONSULTATION PAPER

CESR Proposal for a Pan-European Short Selling Disclosure Regime

Deadline for contributions: CESR invites responses to this consultation paper by **30 September 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests its submission to be confidential.

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1. Introduction and executive summary

1. In the light of very turbulent market conditions and concerns in the second half of 2008 about the threat to financial stability and the associated risks of disorderly markets and market abuse, a significant number of CESR members took emergency measures to restrict and/or impose conditions on short selling. These measures took various forms – some imposed restrictions on all short selling of specified shares or specified categories of shares, some restricted naked short selling and some also introduced disclosure obligations of different kinds. The majority of these measures still remain in place, having been extended or renewed in modified form.

2. As a result of all the activity on short selling regulation, CESR considered that it was appropriate to launch a review of policy on short selling with a view to formulating some pan-European standards in this area. This initiative also reflected the concerns of market participants who have made clear their views about the burdens of having to comply with a number of different sets of national requirements.

3. CESR therefore launched work to examine what permanent regime would be appropriate for short selling within the EEA and also to consider related issues. Without prejudice to the right of the individual CESR members to take or maintain additional measures on short selling, CESR considers that it is important to achieve a harmonised approach to this issue. CESR members have already agreed that a pan-European regime for enhanced transparency of short selling should be implemented on a permanent and harmonised basis. CESR continues to consider whether further measures for the regulation of short selling, beyond disclosure, are required.

4. This consultation paper sets out CESR's proposals for a pan-European short selling disclosure regime. It is based on a two-tier system for the disclosure of significant net short positions held in shares admitted to trading on an EEA regulated market or an MTF. When a short position reaches a specified initial threshold, the position holder (the 'short seller') would be obliged to make a private disclosure to the regulator of the most liquid market for the share in which the position was held. Further such disclosures would be required at specified subsequent increments. If the position reached a second-tier threshold, the short seller would then be required to make also a public disclosure for its position to the market as a whole. Further disclosures would be required if the short positions crossed subsequent incremental thresholds and would also be necessary if the positions fell below the any of the trigger thresholds, including the initial trigger thresholds.

5. In calculating whether a disclosure was required, market participants would need to take account of any position which provided an economic exposure to a particular share. Hence positions in exchange-traded and OTC derivatives would be covered as well as short positions in the cash markets. Disclosure calculations and reports would be done on a net basis with any positions involving long economic exposures to a share subtracted from the short positions. Disclosure reports of short positions – whether to the regulator or the market – would be made on the trading day following that on which the relevant trigger threshold had been crossed. There would be exemptions from the disclosure requirements for short positions resulting from market making activities.

6. Chapter 2 sets out why CESR is proposing a European regulatory regime for enhanced transparency of short selling. It also sets out why CESR favours disclosure of individual significant short positions as opposed to a short sale 'flagging' regime. Chapter 3 then sets out in detail the system which CESR proposes. Chapter 4 provides an impact assessment of the proposals. Annex 1 then lists all the consultation questions.

7. CESR invites responses to this consultation paper. We have listed various questions in order to seek views on specific aspects of the proposed framework. However, we would also welcome any general comments on CESR's analysis and ideas. All contributions should be submitted online via CESR's website under the heading Consultations at www.cesr.eu by 30 September 2009. CESR will consider the responses and publish a final paper by the end of 2009. A feedback statement will also be published.

8. This consultation paper has been prepared by CESR-Pol, chaired by Mr Kurt Pribil, Executive Director of the Austrian Financial Market Authority, and by its Short Selling Task Force.

2. Why CESR proposes enhanced transparency of short selling

9. This chapter provides a brief description of short selling and the benefits and potential problems the practice brings with it. It then sets out why CESR has prioritised development of a pan-European regime for enhanced transparency of short selling via short position disclosure.

Short selling

10. Short selling is generally understood to be the sale of a financial instrument the seller does not own. The seller can undertake a 'covered' short sale by borrowing, before or at the time of submitting the sale order, the instruments he is due to deliver to the purchaser or a 'naked' short sale in which the previous condition is not satisfied. In both cases the seller will at some point need to purchase an equivalent amount of the financial instruments so that it can fulfil its obligations (to the lender or directly to the purchaser).

11. It is important to note that short positions can be obtained through derivatives (whether exchange-traded or over the counter products) as well as by selling in the cash market.

12. Short selling plays an important role in financial markets and is undertaken by a variety of market participants. It contributes to efficient price discovery, increases market liquidity, facilitates hedging and other risk management activities and can possibly help mitigate market bubbles. However, there are some concerns that it can be used in an abusive fashion to drive down the price of financial instruments to a distorted level, can contribute to disorderly markets and, especially in extreme market conditions, can otherwise have an adverse impact on financial stability.

13. CESR has therefore been considering what changes are necessary in the European context to the regulatory framework governing short selling. The objective is to reduce or mitigate the negative consequences and risks which short selling can have without having an undue adverse impact on the benefits which the practice brings to markets.

CESR's prioritisation

14. Although the design of a common disclosure regime has been prioritised so far, CESR continues to consider whether further harmonised measures for the regulation of short selling, beyond disclosure, are required and feasible. As elaborated below, CESR does consider that enhanced transparency has real, justifiable benefits and, accordingly, has decided to prioritise development of a pan-European regime in that space. Other regulatory solutions, like bans or price restrictions, need further analysis.

15. In addition, it is recognised that individual CESR members may need to impose temporary emergency measures (such as bans or partial bans or the imposition of special conditions on short selling). CESR is currently examining whether all its members have the necessary powers to introduce such measures and, if not, what steps may be required to remedy any deficiencies.

16. CESR also respects the right of individual members to maintain their own particular measures on short selling in the light of their judgements of what is appropriate in the specific circumstances of their markets. For example, some CESR members have had long-standing prohibitions on naked short selling.

Enhanced transparency of short selling

17. CESR considers that improving the transparency of short selling would have distinct benefits which would outweigh the associated costs. Greater disclosure would both help deter market abuse and reduce the risks of disorderly markets posed by short selling. It would provide early

warning signs of a build up of large short positions, thereby alerting regulators to potentially abusive behaviour and enabling them to monitor and take action more effectively. Also, facilitating ready access to information on short selling would provide informational benefits to the market, improving insight into market dynamics and making available important information to assist price discovery.

18. As to what form the enhanced transparency might take, there are two basic approaches (although it is possible to use the two in combination). The first involves the 'flagging' of short sale orders – requiring a marker to be put on each individual short sale order that a broker sends to a regulated market or alternative trading venue for execution. Aggregated information about the level of short interest in each security may then be published to the market. CESR understands that information about the aggregate short position in a single share could help the market judge the extent to which short selling is driving down the price of that share and also the extent of the overhang of prospective buy orders when short sellers decide to close out their positions. Flagging also has the potential to give the regulatory authorities real-time data on short selling, including intra-day activity.

19. However, there appear to be inherent imperfections in the data which arise from the mechanics of aggregation, as well as questions about how much value such information adds to other data, such as stock lending data, that is already available. Moreover, flagging of short sales does not provide regulators with information about outstanding short positions in the market or necessarily enable them to identify any large short positions. Nor would it throw light on shorting activity in OTC markets. The fact that individual positions remain anonymous, whilst obviously an attraction for some interest groups, would mean it is less effective as a constraint on aggressive short selling.

20. In addition, no CESR member other than the HCMC currently has a marking requirement or the infrastructure necessary to operate such a system. Therefore, it is likely that introducing a short sale flagging regime would be both operationally difficult and very expensive for both brokers and trading platforms, possibly raising trading costs for all investors.

21. The second approach involves a requirement to report individual significant short positions whether to the regulator and/or the market. What constitutes a 'significant' position will be determined by pre-set thresholds embedded in the disclosure requirement.

22. Requiring the reporting of significant short positions would better enable regulators to identify which parties are taking the lead in short selling and as necessary pursue enquiries with those participants. Requiring those positions to be reported publicly to the market as a whole provides a potential constraint on aggressive large-scale short selling.

23. Obviously there are some downsides to a position reporting regime. First, there are costs to those market participants that have to comply with such a regime. The bulk of these would appear to be incurred in calculating participants' positions in order to determine whether there is a disclosure obligation. However, on the basis of the information available so far, it appears that the compliance costs are considerably lower than for a flagging regime. It is, of course, also relevant to note that the temporary disclosure regimes introduced by the various CESR members since 2008 have been based on the disclosure of significant short positions, so market participants already have some experience and familiarity with this type of regime. Secondly, a position reporting regime cannot aspire to capture real-time data. As discussed below, it is, in effect, a 'snap-shot' of a person's position taken at a pre-determined time. As a result, intra-day positions will not be captured. Nevertheless, on balance, CESR considers that, particularly in the European environment, the second approach is preferable.

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

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

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

24. The short position reporting regime which CESR is proposing is set out in detail in the following chapter.

3. Proposed model for the disclosure of significant short positions

Introduction

25. This chapter sets out CESR's proposals regarding a pan-European model for permanent short position disclosure obligations on as harmonised a basis as possible. The intention is to provide a uniform approach to assist market participants who operate on a cross-border basis in a number of CESR jurisdictions and allow them to utilise their resources in as efficient a manner as possible. A harmonised regime would need to cover a variety of different markets involving different sizes of company, liquidity and market practice. A general issue which readers of this consultation paper may wish to consider is the extent to which a uniform regime, albeit one involving compromises as to its features, is more advantageous than one which, while operating on the same basic principles, would allow for local variations (e.g. different disclosure thresholds).

Scope

26. In most cases where a temporary disclosure regime has been introduced it has been limited to particular, named securities, or particular sectors (e.g. banking and insurance companies). However, CESR considers that a permanent pan-European disclosure model should apply to positions held in all EEA issuers traded on regulated markets or multilateral trading facilities ('MTFs) together with any non-EEA issuers solely or primarily admitted to trading on such platforms. The scope of the regime should therefore not be limited by sector or by the nature of the security (e.g. its liquidity or systemic importance or market capitalisation). There are a number of reasons for this.

27. First and foremost, the risks posed by short selling are not confined to the financial sector and it is not possible to predict with any certainty how the next crisis might develop or which sector might become vulnerable to abusive short selling or disorderly markets. Second, applying the disclosure obligations to only particular categories of security risks 'displacement' of the problems to other areas of the market. Feedback from market participants has indicated that those temporary measures that applied only to financial shares at least caused scope for more aggressive shorting of securities in other sectors (e.g. construction) not covered by the temporary measures. Finally, if it is accepted that disclosure of significant short positions is beneficial, it is not logical to restrict those benefits only to one sector or group of issuers as they apply equally to all.

28. However, CESR considers that there should be two limitations to the scope of the regime. First, only short positions creating an economic exposure to shares admitted to trading on regulated markets and MTFs should be included. The regime is not justified or appropriate for the shares of other issuers or other types of security such as bonds or medium term notes where short selling does not pose the same issues as for equities. Second, the regime should only apply to EEA issuers and those issuers whose shares are solely or primarily admitted to trading on EEA markets. Shares of many other non-EEA issuers have been admitted to trading on regulated markets or MTFs but it would not be appropriate for the regime to include them within its scope regardless of what standards are applied on their home markets.

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

A two-tier disclosure system

29. Of the various disclosure models which have been considered, CESR favours a two-tier system involving a mixture of private and public disclosures and based on the net short position (howsoever obtained) expressed as a percentage of the company's issued share capital. Once a

net short position had reached a specified first trigger threshold it would need to be disclosed to the relevant regulator. If the short position then reached a second, higher threshold, an additional obligation to make a public disclosure to the market as a whole would be triggered.

30. CESR considers that short positions of a given size do warrant public disclosure and that their private disclosure to the regulator alone would not achieve the same benefits. As previously noted, public disclosure of significant short positions would provide the market with valuable information that a share of a particular issuer may be over-valued, allowing it to react rationally and in an orderly fashion. Second, and perhaps more important from the perspective of helping to prevent market abuse and disorderly markets, public disclosure should provide a measure of deterrence to aggressive short sellers beyond what would be gained from a requirement to disclose to the regulator alone.

31. CESR is aware of the argument that excessive transparency could expose the short position holder to the risk of a short squeeze and thus reduce the benefits which short selling provides to the market. Whilst acknowledging that no study has looked systematically at this issue, the experience of those CESR members who have operated public short position disclosure is that, so far at least, there has not been evidence of short squeezes. It is also the case that short sellers have been prepared to take positions which require public disclosure so that transparency does not necessarily act as a barrier to short selling. In addition, CESR notes that there are precedents for the public disclosure of private information (for significant long positions under the Transparency Directive and managers' transactions in the shares of the company they work for under the Market Abuse Directive).

32. There is also the argument that public disclosure, particularly by 'big-name' or influential market participants, can lead to 'herding' behaviour whereby others seek to take advantage of this by then short selling the financial instruments of the issuer in question themselves. The concern is that this would create a disorderly market in the issuer's shares. Again there is little or no evidence from CESR jurisdictions with public disclosure regimes that this has actually occurred. However, CESR accepts that this does underline the importance of setting the threshold for public disclosure at an appropriate level. This is discussed in paragraphs 38-44 below

33. There are various reasons why CESR is proposing that the public disclosure requirement is supplemented by an obligation to make disclosures to the regulator at a lower threshold. First, CESR recognises that some short sellers may not wish to trigger a public disclosure of their positions and therefore keep them just below the relevant threshold. To track what is happening in particular shares regulators would benefit from knowing which market participants have positions which, while not large enough to warrant public disclosure, are still nevertheless significant. In the absence of such disclosures, it can be very time and resource consuming to identify such parties from transaction reporting data – and only a partial picture may be obtained.

34. Second, as noted at the start of this chapter, if there is one public disclosure threshold applicable across all European markets, there may be some markets for which the threshold is less than ideal. The requirement to privately disclose lower positions will particularly help in such markets.

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)?

Disclosure thresholds

35. CESR recognises that identifying disclosure thresholds that would generate meaningful information is crucial. If the thresholds are set too high, then disclosures may be rarely triggered so that regulators may not receive sufficient advance warning of possible market abuse or impending disorderly markets and the market may not receive enough information to help it make informed investment decisions. If the thresholds are set too low, then the 'warnings' sounded to regulators may be of little value and the compliance costs for market participants may be high and not justifiable. In addition, large numbers of disclosures of positions that are not considered by the market to be meaningful are of questionable value. In particular, the initial public disclosure threshold needs to be set at a level which provides to the market meaningful information about the size of positions and the identities of short sellers, whilst minimising the degree to which trading strategies which may not risk creating disorderly markets are deterred.

36. There is the question of whether it would be appropriate to apply a single threshold in all EEA markets; what might be appropriate in a large liquid market may be less so in smaller ones. CESR notes that, in its report on short selling, the European Securities Markets Expert Group ('ESME') chose[1] not to recommend a specific threshold, observing that "Aspects to be taken into consideration should include the free float in a certain share, the daily turnover, the market capitalization as well as the question whether the threshold should be applicable on a gross or a net position".

37. Ultimately a choice needs to be made between the complexity of the requirements and the extent to which they are tailored to the circumstances of particular markets. On balance, CESR considers that the benefits of harmonisation will outweigh the disadvantages of having uniform thresholds and is therefore proposing that, with one exception for rights issues discussed in paragraph 45 below, there should be one set of disclosure thresholds applicable to all EEA jurisdictions.

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?

38. As regards the threshold for public disclosure of short positions, some market participants have stated that they favour mirroring the disclosure obligations that apply to long positions held in shares – i.e. the Transparency Directive only requires disclosure when the position is equivalent to 5% of the voting rights. However, long disclosure obligations are not attempting to address the same issues as those relating to short positions. The latter are intended to mitigate the risks posed by short selling to orderly markets and/or market abuse. By contrast, a long disclosure obligation seeks mainly to enhance transparency regarding who controls a company (by providing information about the voting rights people hold in companies). The long position trigger threshold therefore needs to be seen against the background of voting rights attached to all issued shares, because all the shareholders may exercise their voting rights. A short position should be considered against the market impact of the transactions in the relevant share, implying a much smaller fraction of the issued share capital.

39. When regulators around the world introduced disclosure obligations during the autumn of 2008, many coalesced on a single threshold level of 0.25%. This level was generally considered to be significant for the purposes of adding extra transparency to short selling in financial sector shares and their related instruments. However, it is relevant that this level was applied in an emergency situation and was usually associated with either full or partial bans of short selling in the affected securities.

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[1] ESME Report on Short Selling 19 March 2009.

40. CESR proposes that the public disclosure threshold should be higher than that introduced last year in relation to financial sector shares. Firstly, the proposed model would apply to positions held in all shares admitted to trading on a regulated market or an MTF. Generally speaking, a short position in a (large, often systemically important) financial sector company becomes significant at a lower percentage level than a short position in the issued share capital of issuers in other sectors. Secondly, given that CESR is also proposing that there should be a lower, private disclosure trigger, regulators would already have had advance notice of building short positions in the issued share capital of a particular issuer and would already have had the opportunity to consider their response.

41. There is some limited evidence[2] to indicate that a figure of 0.50% would strike the right balance and CESR therefore suggests this figure as the level for the public disclosure threshold but will be very interested in the views of market participants.

42. As regards the threshold for a private disclosure to the regulator, CESR believes that 0.10% of the issued share capital of the company whose shares are being short sold is an appropriate level for the initial disclosure threshold. This would allow regulators to be informed about short selling in a particular share at a relatively early stage.

43. CESR also proposes that both for the private and public disclosure regimes steps of 0.10% are used as incremental threshold bands to trigger further disclosure obligations on change of a short position (either up or down), after the initial disclosure obligation has been incurred. Thus further notifications to the regulator would be required at 0.2%, 0.3% and 0.4%. Further notifications to the public and to the regulator would be required at 0.6%, 0.7% etc. Disclosures would also be required at the point at which the short position fell back below any of the trigger thresholds, including the initial trigger thresholds.

44. Finally, CESR agrees with IOSCO[3] that "reporting of short positions is a "greenfield" area" and that "reporting threshold or trigger levels …may need to be fine-tuned as more experience is gained." Thus whatever the thresholds chosen, there should be a review of their suitability after sufficient experience had been gained in their operation.

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

Rights issues

45. CESR recognises that there may be circumstances when companies are more vulnerable than normal to short selling – regardless of the sector they are in. The obvious case is when companies are raising capital through, for example, rights issues. CESR considers that account should be taken of these periods of particular vulnerability and recommends that tighter than normal public disclosure obligations apply for such periods. A lower public disclosure threshold – e.g. 0.25% - could be applied in such circumstances. These tighter thresholds could be introduced on a permanent basis or even on a temporary basis, with regulatory discretion as to when they are imposed. CESR proposes that in the case of rights issues the obligation for 'private' disclosure to the regulator should still be triggered at 0.1%.

[2] This is based on the experience of the UK which analysed the first set of disclosures made after it introduced disclosure requirements for short positions in UK financial sector companies on 19 September 2008 and found that the mean position disclosed was 1.05% and the median position disclosed was 0.51%. Subsequent disclosures were not analysed as the FSA had introduced a ban on short selling at the same time and, therefore, expected short positions to decrease over time. The CNMV also analysed the first set of disclosures of short positions on protected stocks that they received and ascertained that the mean was 0.43% and the median was 0.32%. In the case of the AMF experience of disclosures under its temporary measures, both the mean and median positions disclosed were approximately 0.39%.

[3] IOSCO Regulation of Short selling - Final Report, paragraph 3.23.6 p. 14.

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?

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

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?

The basis for calculating short positions

46. Calculation of short positions can be done on either a gross basis or a net basis. CESR considers that a gross basis may not be that meaningful to market participants since there could be offsetting long positions and the disclosure would not reflect the true exposure. Market users would have to try to calculate the total exposure that a short seller has to a particular issuer. The short seller would not bear the costs for these calculations.

47. Using a net basis would mean that a more accurate picture of the actual short position would be disclosed. This information would be more useful to both regulators and market participants and the costs for calculating these positions would fall on the short seller. Accordingly, CESR proposes that a net basis is used to calculate short positions.

48. As regards how the net position is calculated, this should be done by taking into account transactions in all financial instruments that create an economic exposure to the issued share capital of the issuer. In other words, the net short position would not be limited to that taken in the cash equity markets, but would also extend to positions in linked derivative contracts (whether exchange-traded or OTC). The 'economic exposure to the issued share capital of the issuer' should be calculated taking into account all classes of shares admitted to trading on a regulated market or an MTF. Although, in Member States where issuers may have several share classes it would be necessary to consider whether positions should be calculated and disclosed separately in relation to each share class. In some jurisdictions it may be necessary also to take into account the total number of issued shares and/or (depending on the nature of the shares) the face value of the shares. Derivative positions would be calculated on a Delta-adjusted basis.

49. Another important factor regarding calculation of the position is the level within a group at which the calculation is made. There may be a number of trading desks or funds within one legal entity or managed by it. Alternatively, a group may contain a number of different legal entities. Given that under CESR's proposed model, holders of short positions can net off short positions against opposing long positions held in the same issuer, it is important to minimise the extent to which this netting procedure can be exploited, in a group context, to avoid a disclosure obligation. Accordingly, whilst CESR recognises that both options (i.e. netting off at either the legal entity or the group level) have their pros and cons, it proposes that the netting calculation should be done at legal entity level, considering separately, where relevant, proprietary trading from market making activity (see below 'exemptions to disclosure obligations'). However, the details of how precisely this should work in practice require further discussion and input from market practitioners.

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?

The mechanics of disclosure

50. CESR proposes that private disclosures to regulators are submitted to a dedicated e-mail address at the competent authority and that public disclosures are made in a manner ensuring fast access to such information on a non-discriminatory basis. For shares admitted to trading on multiple EEA markets, the disclosures to regulators should be made to the competent authority of the most relevant market in terms of liquidity as per Article 25(3) of MiFID. However, CESR notes that the home state authority for the issuer, as defined in the Transparency Directive, if

different from the above mentioned, may need access to this information for its own supervisory and investigative purposes. CESR therefore would stress the importance, in this context, of effective co-operation between the competent authorities of Member States, as contemplated by the CESR MoU. The responsibility for making the disclosures would rest with the position holder, although it would be acceptable for an agent of the position holder (such as its broker) to handle the disclosures. As regards the information to be contained in disclosures, it should at a minimum include the identity of the short position holder, the identity of the issuer, the size of the position held and the date on which the position was created or was no longer held.

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

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).

Timing of disclosures

51. Information about short selling should be disclosed as soon as possible so that users of it, whether regulators (acting on both private or public information) or market participants (acting on public information), can make informed decisions on whether any action on their part is warranted. Delaying disclosures unnecessarily will lessen the value of the information but, equally, requiring disclosures to be made too quickly may unnecessarily burden the short sellers who are making the disclosures. Experience from the temporary disclosure obligations introduced since autumn 2008 has shown that systems can cope with calculating (and then disclosing) short positions within a day of the trading taking place. CESR believes that this is a reasonable timeframe and sufficiently prompt to make the disclosure meaningful to both regulators and market users.

52. Consequently CESR proposes that disclosures are made at a specified time before the end of the trading day following the day on which the disclosure obligation is triggered (i.e. T+1). CESR recognises that intra-day positions that breach a disclosure threshold, but which return below that same threshold before the end of the trading day, will not be captured. To some extent, this is an inherent feature of a position disclosure regime (rather than the timing of the required disclosure), which effectively captures a 'snap-shot' taken at a pre-determined time. Real-time disclosure is neither feasible nor, from a compliance perspective, desirable.

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

Exemptions to disclosure obligations

53. The current temporary measures in some Member States contain exemptions to disclosure obligations for persons providing liquidity to the market in a specified and sustainable way. These persons are often called market makers. For the purposes of these measures, a market maker has generally been defined as being an entity that, ordinarily as part of its business, deals as principal in equities, options or derivatives (whether OTC or exchange-traded):

    i. to fulfil orders received from clients or in response to a client's request to trade or to hedge positions arising out of those dealings; and/or

    ii. in a way that ordinarily has the effect of providing liquidity on a regular basis to the market on both bid and offer sides of the market in comparable size.

54. Generally, trading in circumstances other than genuinely for the provision of liquidity is not exempt.

55. Market makers play an important role in the financial markets through the provision of liquidity by offering two-way prices on an ongoing basis. This activity is vital to the efficient and effective running of the markets. As part of their market making function, the firms in question regularly have to take short positions (generally temporary ones) and may be at risk of short squeezes if those positions are known to the market. CESR therefore proposes that market makers should be exempt from any general disclosure regime based on individual short positions. In making this proposal, CESR would emphasise that its principal objective is to ensure that liquidity provision is not unduly hampered by the disclosure regime that it is proposing.

56. The exemption would only cover market makers when, in the particular circumstances of each transaction, they are genuinely acting in the capacity of a market maker. They are afforded a certain level of flexibility in anticipating sales as long as this activity is genuine market making in line with its existing general levels of business. Consequently, CESR would not expect market makers to hold significant short positions, other than for brief periods. Proprietary trading, where a firm is acting more as an investor or trader rather than liquidity provider, would not fall within the scope of market-making and would not be exempt.

57. Since short positions do entail more risk for market makers than long positions, on balance, CESR proposes that their exemption under the short disclosure regime should be an absolute one (i.e. in relation to both private and public disclosure).

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?
Q16 If so, should they be exempt from disclosure to the regulator?
Q17 Should CESR consider any other exemptions?

The legal basis for a permanent disclosure regime

58. One of the critical requirements of a permanent disclosure regime for short selling is that it should apply to the unregulated as well as the regulated community. There is clearly no point requiring regulated entities to disclose their short positions, for all the reasons set out above, if, for example, hedge funds operating outside the EEA do not have to do so. This was a significant factor for many CESR members when they opted for the market abuse regime as the mechanism for implementing their temporary measures. Additionally, measures covering only regulated entities would also create an unlevel playing field.

59. However, CESR considers that EEA securities regulators should be given explicit, stand-alone powers to require disclosure in respect of short selling. This would provide confidence in the clarity and legal soundness of such requirements, allow for flexibility and minimise the scope for legal challenge to the use of such powers.

60. CESR would therefore recommend that there should be European legislation in this area, either via the enactment of a separate directive or regulation or through amendments to the Transparency Directive. Given that CESR does not envisage that a short position disclosure regime should employ the same disclosure thresholds as the long position disclosure regime and that there are a number of other areas in which these proposals diverge from the long position regime, proceeding via a new directive or regulation, rather than through an amendment to the Transparency Directive, would look to be more suitable.

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?

4. Impact assessment

61. This Impact Assessment describes the economic costs and benefits of the proposed two-tier short selling disclosure regime of significant individual short positions.

Benefits

62. As discussed in chapter 2. of this paper, the proposed disclosure regime can help to address potential market abuse and disorderly markets. It can further provide informational benefits to the market by improving transparency of short positions.

63. *Market abuse* – The first element of the disclosure regime, private disclosure of short positions to the regulator at a low threshold (i.e. 0.1%) provides regulators with early warning signs of a build up of large short positions. This allows regulators to monitor the situation and can alert them to potentially abusive behaviour. They might therefore be able to take action more effectively. Without a disclosure regime, identification of significant short sales would be resource-intensive for regulators. CESR recognises the limits to these benefits, as short sellers might operate below the disclosure threshold. This issue is mitigated by proposing a relatively low threshold for private disclosure to the regulator. However, short sellers might also fail to comply with the disclosure obligation.

64. *Disorderly markets* – Disclosures of short positions to the regulator at a relatively early stage may help to identify unusual short selling activity. This helps regulators to identify whether short selling activity potentially leads rise to price amplification effects (if markets 'over-react' to the negative price signal inherent in short selling) at an early stage and to determine whether intervention is required.

65. *Transparency* – The second element of the disclosure regime, public disclosure of individual short positions above a second and higher threshold (i.e. 0.5%) generates information for market participants on the size of significant short positions above this second disclosure threshold. It also provides information about the identity of significant short sellers in the relevant stocks. If this information is interpreted correctly by the market, this provides insight into short sellers' price movement expectations and can improve pricing efficiency.

66. Providing appropriate information to the market as well as minimising the potential negative side effects of making individual short positions public depends on the level at which the public disclosure threshold is set. When setting the threshold, a balance needs to be struck between providing too much information which is not meaningful (if the threshold is set too low) and not capturing potentially important information (if the threshold is set too high).

Costs

67. Disclosures of individual short positions would impose compliance costs on market participants engaging in short selling. These costs are related to monitoring short positions, making appropriate disclosures to the regulator and the market and, in some cases, seeking legal advice on the nature of the disclosure obligation.

68. It is likely that the major part of these costs is generated by monitoring short positions as firms may need to incur one-off costs to adjust their internal systems. The size of the costs due to the implementation of a permanent disclosure regime across the EEA depends on the complexity of the business of a short seller and on the systems for monitoring short positions that are already in place. Market participants will also have ongoing costs to monitor their short positions.

69. Making the appropriate disclosures to the regulator and the market will lead to further ongoing costs. However, as described in paragraph 50 CESR proposes that disclosures to the regulator

can be made via email. At this stage, it is more difficult to assess the costs of the disclosures to the market. CESR however believes that the costs of making these disclosures are relatively small.

70. CESR does not expect that the levels at which the disclosure thresholds are set will have major impacts on compliance costs to firms. This is for two reasons. Firstly, these levels are unlikely to have major impacts on one-off costs to update internal systems necessary for complying with the disclosure obligations. Secondly, although the levels of the thresholds will affect the number of disclosures that need to be made, as stated above, CESR does not expect the costs of making disclosures to the regulator and to the market to be great.

71. When considering compliance costs, it is also worth noting that the operation of different disclosure threshold regimes could add to firms' compliance costs as this is adding complexity. In this context, it is important to note that CESR is proposing a harmonised disclosure regime that employs uniform thresholds that apply across all EEA jurisdictions. Such an approach is likely to lead to lower compliance costs for market participants operating across borders, than those associated with a regime in which different disclosure thresholds apply in different jurisdictions within the EEA. However, CESR is proposing that during rights issues a lower public disclosure threshold should apply.

72. Public disclosures of short positions might also lead to indirect costs for short sellers. Short sellers might have competitive disadvantages if others follow their short selling strategy. They might also face a short squeeze, i.e. increased costs of closing their short positions if other market participants are alerted to their need to do so. However, as noted in paragraph 31 of this paper, there is little or no evidence from CESR jurisdictions that have operated public disclosure regimes that short squeezes have actually occurred in the market. While, overall, public disclosure obligations might reduce firms' willingness to hold short positions, the extent to which this might happen is unclear. If this does happen in practice, then it will also reduce liquidity in the market with all the associated indirect costs that that brings.

73. The actual level of the public disclosure threshold is relevant to the size of this potential cost, with a higher threshold associated with lower indirect costs.

74. Another indirect cost of public disclosure of short positions concerns potential over-reactions to the information disclosed by market participants. This risk is likely to be higher in times of severe market turbulence. This may lead to an increase of short selling due to herd-like behaviour, resulting in excessive sales of shares and price declines following disclosures of short positions to the market.

75. Regulators would also incur costs as compliance with the private and public disclosure requirements needs to be monitored and, if necessary, enforced.

ANNEX

LIST OF CONSULTATION QUESTIONS

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

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

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

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

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)?

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?

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

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?

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

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?

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?

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

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).

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

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?

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

Q17 Should CESR consider any other exemptions?

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?