



CESR Releases Technical Details of the Pan-European Short Selling Disclosure Regime

On 26 May 2010, the Committee of European Securities Regulators (“CESR”) published technical details in respect of its proposed model (the “Model”) for a pan-European short selling disclosure regime (the “Second Report”).¹ These details follow and should be read in conjunction with the publication of an earlier CESR report and feedback statement that set out proposals for the Model on 2 March 2010 (the “First Report”).²

Background – The Model

As outlined in our update on 9 March 2010,³ CESR’s First Report provides initial details of a regime, whereby short sellers will be required to make private disclosure to their relevant national regulator, at the end of each trading day when their net short position reaches 0.2% of an issuer’s issued share capital. Each further movement of 0.1% of issued share capital (upwards or downwards above the 0.2% threshold) will then trigger further disclosure obligations to the regulator. Once the net short position is greater than 0.5% of the issuer’s issued share capital, the short seller will have to make a public disclosure of its position to the market as a whole.

The Model is only proposed to apply to EEA issuers with short positions that create an economic exposure to shares admitted to trading on an EEA-regulated market and/or an EEA Multilateral Trading Facility (“MTF”). It will also apply to all equities and will not be limited by sector or the nature of the relevant security.

CESR’s initial description of the Model in its First Report provided high level information in respect of the two tiered disclosure system referred to above. The Second Report, however, aims to provide further technical details in respect of CESR’s proposed regime, as set out below.

Calculating the Net Short Position

A short seller’s net short position, calculated by netting its long and short positions, will need to be determined at the end of each trading day. Intra-day positions will not have to be disclosed. Such calculations must take into account all instruments that give rise to exposure (whether direct or indirect) to the issued share capital of a particular company. These may include futures, equity swaps, contracts for differences, spread bets, options or short sales in the cash markets. Economic interests held as part of a basket, index or exchange traded fund, and derivatives products relating to an index must also be taken into account when considering a position with respect to a particular share.

¹ Committee for European Securities Regulators, “Technical details of the pan-European short selling disclosure regime,” CESR/10-453, May 2010: http://www.cesr.eu/data/document/10_453.pdf.

² Committee for European Securities Regulators, “Model for a pan-European short selling disclosure regime,” CESR/10-088, March 2010: http://www.cesr.eu/data/document/10_088.pdf.

³ MoFo, “CESR Proposals for a Pan-European Short Selling Regime”: <http://www.mofo.com/files/Uploads/Images/100409CESR.pdf>.

All derivative and cash positions must be accounted for on a “delta-adjusted” (as opposed to “notional”) basis. This is because derivative instruments are considered to have an economic effect (in respect of the underlying assets represented) in a proportion equal to the delta⁴ of that instrument at any particular point in time. Accordingly, short sellers will have to consider the delta value of each derivative instrument held in a particular portfolio, plus or minus all cash positions. CESR proposes that this delta value be calculated taking into account the implied volatility of the derivative and the closing price of the underlying share or other instrument. It notes that instruments giving entitlement to shares not in issue when the position is calculated (such as convertible bonds or nil-paid rights) should not be taken into account.

What Constitutes Issued Share Capital?

CESR’s references to issued share capital should be determined on the basis of the entire issued share capital of the relevant company. This will include both ordinary and preference shares, but not debt securities (including convertible bonds). Consistent with the above, instruments giving entitlement to shares not in issue should also not be taken into account. In respect of any capital increases (capital raisings, bond conversions etc), CESR considers that such increase will come into effect when the new shares have been admitted to trading on a regulated market or MTF.

Calculating Changes of Net Short Positions

Swapping an existing instrument that generates a particular short position, for another type of instrument that generates a different short position, will not of itself necessitate the requirement to make a disclosure. Similarly, changes to the delta of a particular portfolio will also not automatically require that a disclosure be made, unless they take the net short position over the reporting threshold. Disclosures are only required in circumstances where the net short position, calculated at the end of a particular day, actually changes.

Netting and Aggregation with an Organisational Structure

The view taken in respect of reporting within an organisational structure, is that netting of short positions would be inappropriate at the group level, where the market impact of lower level short positions would not be reflected. CESR also point out that it wishes to avoid the possibility that group structures can be used to avoid compliance. For example, a significant short position in one entity of a financial services group should not avoid disclosure on the basis of a completely unconnected long holding elsewhere in the group. Consequently, disclosure should always take place at the level of the person who is making the relevant investment decision.

The Mechanics of Disclosure

CESR’s overriding objectives for the reporting of disclosure are: speed, security, timeliness and certainty (as regards legality and identification). In addition, the mechanism used will need to be able to cope with the expected number of disclosures.

In order to facilitate implementation in the short term, CESR recommends manual reporting (i.e., via e-mail to the applicable regulator, in the case of private reporting, or via a Regulatory Information Service (or equivalent) in the case of public reporting). However, recognising the potential deficiencies of such a mechanism (including security concerns and the potential impact on the resources of both investors and regulators), CESR is proposing to leave it open to Member States to design and operate automated systems. Such automated systems would have to meet the objectives referred to in the paragraph above. The example CESR provides is the establishment of a central repository for short position reports at a national level (i.e., the competent authority). CESR is also presently analysing the possibility of further harmonisation via a central European repository and publication mechanism.

⁴ Delta is a ratio which represents the movement in an instrument’s value as the value of its underlying reference asset changes.

Exemptions from Disclosure Obligations

As mentioned in the First Report, CESR restated its view that market makers, who are genuinely acting in their capacity as providers of liquidity in the market, should be exempt from disclosure obligations. Accordingly, it has provided the following definition of exempt persons:

“An investment firm (or equivalent third-country entity), or a local⁵ 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:

- 1. 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; and/or*
- 2. as part of its usual business, to fulfill orders initiated by clients or in response to clients’ requests to trade, and to hedge positions arising out of those dealings.”*

This exemption should apply to both private and public disclosure. However, parties wishing to take advantage of the above exemption will have to notify a relevant CESR member of their intention to do so. Such CESR member may decline the request.

Implementation

CESR has recommended that its members, who already have the power to introduce such a short selling disclosure regime, should start the process of implementing it. In respect of those members who do not yet have such power, they should seek to implement the regime on a best-efforts basis.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁵ “The notion of local refers to the exemptions provided by article 2(1)(d) and (l) in connection with articles 42(3) and 14(4) of MiFID.”