The long and short of it

Cesr's proposals on pan-European short selling rules create valid concerns about public disclosure and its effect on liquidity

On March 2 2010, the Committee of European Securities Regulators (Cesr) published its proposed model for a pan-European short selling regime, which is based closely upon the proposals it issued for consultation in July 2009.

The practice of short selling, whereby a investor agrees to sell shares it does not own, has come under the spotlight during the financial crisis. During the period of extreme market volatility in the aftermath of the Lehman Brothers collapse, many national regulators, including in the US and the UK, imposed bans on the short selling of shares in financial sector companies. Although most of these bans have now been lifted, many jurisdictions have introduced requirements for disclosure of short sales or short positions – either publicly or privately to the relevant regulator. To date, there has been no co-ordinated approach within the EU, leaving decisions to be taken entirely at national level.

The Cesr proposals seek to provide a regime for the disclosure of short positions in shares applicable throughout the European Economic Area (EEA), facilitating a consistent approach. Cesr's proposals will apply to all equities (so not limited to the financial sector) and will apply to short positions creating an economic exposure to shares trading on an EEA-regulated market or an EEA multilateral trading facility.

Cesr proposes a mix of private and public disclosure. The private disclosure regime would have an initial threshold of 0.2% of the issued share capital of the relevant entity and will have to be made to the relevant national regulator. The public disclosure regime would have an initial threshold of 0.5%. For both the private and public disclosure regimes, there will be an additional disclosure requirement, where the relevant net position goes up or down by each 0.1% increment subsequent to the initial disclosure.

The disclosure regime applies to a party's net short position, thereby enabling a party to offset its long positions against its short positions. In calculating a net short position, a party will be required to take into account its economic exposure under derivatives and exchange-traded funds. Cesr has stated that it will publish further details on the mechanics of the disclosure requirements. Equally it believes disclosure should be made at a specified time – before the end of the trading day following the day on which the disclosure obligation is triggered.

Cesr also proposes that there should be a market-maker exemption to these requirements and proposes to publish further proposals in due course. It states, however, that such exemption should only apply to parties genuinely acting in such capacity.

Although Cesr's objective is to provide a uniform disclosure requirement in relation to short positions, the requirements will create minimum standards for EEA member states. So it will be possible for individual states to impose additional requirements or to introduce permanent or temporary prohibitions on short selling activities. For example, several member states have naked short selling bans and it is quite possible these will remain in place, notwithstanding the CESR proposals. Although Cesr notes in its report that it will consider whether further harmonised measures relating to short selling are necessary or feasible, it states that its objective is to facilitate greater transparency of short selling activities.

There are concerns about downsides to a public disclosure regime. In jurisdictions such as the UK where a public disclosure regime has been introduced, there has been a fall in trading volumes in relation to shares covered by the regime which has led to a fall in liquidity, increased costs and an increase in bid-ask spreads. These concerns have been raised notably by the Managed Funds Association, which favours a private disclosure regime.

Although the Cesr proposals contain a mix of public and private disclosures, it remains to be seen what effect the 0.5% threshold for public disclosure has on trading volumes. This threshold is consistent with the position favoured by the FSA in the UK, which has previously suggested a 0.5% threshold to all companies, which is above the FSA's current 0.25% threshold for public disclosure of short positions in relation to financial sector companies (or other companies subject to rights issues).

It should be noted that the UK FSA also favoured a lower 0.25% threshold level for public disclosure of net short positions in relation to companies subject to rights issues. This proposal has not, however, been adopted by Cesr. It remains to be seen whether the FSA continues to favour a separate, lower threshold in relation to rights issues or is satisfied that a private disclosure regime, with a 0.2% threshold, provides sufficient transparency in such circumstances. It is quite possible that the FSA will follow Cesr's proposals, dropping the lower rights issues threshold in favour of the private disclosure option. The FSA and regulators in other member states are, of course, still free to impose their own measures on short selling, including emergency bans, if financial market conditions deteriorate.

So, what should financial services firms do to ensure they are compliant with Cesr? Appropriate systems need to be in place so that the net short position may be calculated effectively and to ensure that disclosures are automatic and timely. In the UK, maintaining an open dialogue with the FSA will facilitate the compliance process. The time and costs associated with such efforts will not be wasted; there can be no doubt that the short selling regime will remain under review by Cesr and national regulators for some time to come.

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