CFA INSTITUTE | Centre for Financial Market Integrity

The Committee of European Securities Regulators
11-13 avenue de Friedland
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London, 29th September 2009

Consultation paper on CESR Proposal for a Pan-European Short Selling Disclosure Regime

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on CESR Proposal for a Pan-European Short Selling Disclosure Regime (the "Consultation").

The CFA Institute Centre[1] promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We believe short selling is a legitimate investment activity. In enabling markets to quickly and accurately adjust securities prices to reflect investors opinions about valuation, short selling benefits the market as a whole and is a powerful tool in the hand of investors. In a survey conducted on our global membership in May 2009, 48% of respondents "strongly agreed" and 41% "agreed" that short selling benefits the market by providing price discovery and market liquidity[2].

We are broadly supportive of CESR's effort at convergence in this area. The wave of short selling bans that took place in autumn 2008 throughout the EU not only showed a lack of coordination between EU securities regulators, but most importantly posed a concrete threat to the functioning of the internal market. That experience still stands today as the most powerful argument in favour of the creation of a robust and legitimate EU short selling regime.

In order to achieve this, we feel that more resources should be devoted to the development of an agreed definition of the object of the regulation. We refer in particular to "aggressive short selling".

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[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

[2] Complete results and methodology available at : http://www.cfainstitute.org/aboutus/press/pdf/short_selling_survey_results_2009.pdf

It is in fact difficult to provide concrete evidence, as explicitly requested by CESR during the Open Hearing held on 9th September, on a new pan-European regulation that would find its main rationale in the prevention of a phenomenon that has not, so far, been described thoroughly and that lacks an agreed definition.

Another crucial area where more needs to be done is the assessment of the costs involved in the different policy options. The data received by market participants can potentially be biased, and may either overestimate or underestimate the costs of a new regulation. As a consequence, we urge CESR and in particular the authorities part of the Short Selling Task Force to independently define the impact of what it is being proposed.

Finally, we believe that a comprehensive short selling regime should address crucial issues such as bans, post-trade disclosure, settlement, and in particular naked short selling. We look forward to receiving more information on the next steps.

For what concerns the preliminary suggestions made by CESR, we are aware of the additional implementation costs posed by the flagging option. However, we believe that, in parallel with the introduction of a consolidated tape, flagging can bring greater benefits and avoid some of the problems connected with disclosure and market abuse.

As for the individual public disclosure to the market we strongly believe that disclosure should be anonymous, in order not to deter short sellers from what is a legitimate and useful investment strategy. Moreover, we are also convinced that short sales data should be published in aggregated form. This is why we do not agree with the system proposed by CESR as it stands in this proposal.

Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,

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The CFA Institute Centre is part of CFA Institute[3]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 137 countries, of whom nearly 88,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our detailed comments follow the order of the Consultation's questions.

SPECIFIC COMMENTS

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

Yes, we agree, though it depends upon what is disclosed. A timely, accurate and transparent disclosure regime would be beneficial. First, this would eliminate the informational advantages possessed by some professional investors. Second, it would help to fight widespread and false assumptions about this market activity, such as the idea that it is a quasi-abusive strategy that benefits the few. Finally, it would help the market to understand the degree of short interest.

It would therefore help investors make better investment decisions.

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

Flagging is our preferred option. It would yield useful information to regulators and assist them in understanding the market. Whilst we recognise that flagging would carry implementation costs, we believe these should be considered in the context of other needed improvements in the post-trade transparency regime, such as the consolidated tape.

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

See our response to Q2.

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

No, we agree with the scope of the regime and with the trading venues it would cover.

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

[3] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

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)?

No. Such a system may deter legitimate short selling. Named disclosure would make investors less willing to sell short, thereby impairing price determination and creating as a consequence negative spillovers on the market as a whole.

In our opinion flagging preserves the benefits of anonymity and has the potential to provide real time information. This latter advantage narrows the opportunity for malicious rumours on alleged shorting activity to circulate in the market.

Finally, named disclosure would expose short sellers to additional market risks (such as retaliation on the part of issuers, or possible squeezing). Moreover, identification of short sellers could send the wrong message to the market, as this may misinterpret a short sale disclosure without being able to assess whether it is part of a broader strategy.

If, as CESR rightly declared, one of the declared objectives of short selling disclosure is to help market participants and assist price discovery, we do not see the rationale for named disclosure.

An additional important point worth considering here, is the lack of definition concerning "aggressive" short selling. Throughout the paper, and during the open hearing organised on the 9th of September, CESR has not been able to provide us with a definition of what "aggressive" short selling is. We would like to see a definition of such practice: for example a quantitative threshold linking the percentage of short sales on a security with its percentage price decline during a trading day.

It is difficult to provide concrete feedback on a new pan-European regulation that would find its main rationale in the prevention of a phenomenon that has not, so far, been described thoroughly and nor has an agreed definition.

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?

We agree that convergence is necessary, primarily to avoid unnecessary legal costs on market participants and on a higher level not to compromise the functioning of the Single Market. However, it is imperative that common definitions are in place in any jurisdiction before proceeding with the implementation.

It is also true that smaller markets may have to sustain a disproportionate regulatory burden with the thresholds suggested at the moment.

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

We do not agree with the proposal for a number of reasons. We believe, for the reasons expressed above, that more consideration should be given to the objectives of the proposals and then to the proposed thresholds. Furthermore, we would like to see the results of impact assessment studies before proceeding with the setting of the thresholds.

There is no mention in the consultation of important issues such as the free float of a stock or market capitalisation, and how they may impact the meaningfulness of the data disclosed and their utility to investors.

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?

Rights issues and the shorting activities of underwriters may give cause for concern. Where knowledge of this activity is withheld from the market, there is opportunity to mislead. We believe there is an ethical issue at stake: underwriters can exploit non-public information for their own gain, at the cost of both investors and issuers.

As such, we believe that underwriters should not be allowed to sell short from the announcement of an offering throughout the marketing of the issue, though stabilisation in the post offering period is acceptable. We believe shorting activity by underwriters prior to the announcement of a right issue should raise concerns about violation of the Market Abuse Directive framework.

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

No, we are against the disclosure of individual short positions to the market. The regulatory framework should possess enough legitimacy as to be applicable under any circumstance. If anything different must be applied to rights issues, this should rather take the form of more stringent controls under the Market Abuse Directive.

This would deter abusive behaviours and at the same time prevent any reduction of the level of market efficiency.

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, we believe no other circumstances should give rise to exceptions.

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?

Market participants may be more interested in knowing the percentage of short interest to shares outstanding, something that is not conveyed by net position.

Moreover, it is possible to exploit the net disclosure requirement. By purchasing an off-setting position via a call option in the security that was well out of the money it is possible to avoid the disclosure requirement[4].

This said, our main concern relates to the costs associated with disclosure: despite being fully sympathetic towards increased transparency, we also understand the costs this imposes on market actors, in particular those operating in multiple EU jurisdictions. The problem of aggregation, already incurred when calculating positions under the Transparency Directive, may become even more problematic with these additional requirements. In order to alleviate costs and ease compliance mechanisms, we therefore urge CESR to devise calculation methods that would not be too much dissimilar from those already used under other EU laws.

Finally , we would like to point out the problem posed by indexes. When shorting an index, market actors do not express a view on a particular share, but rather on a whole market. We feel there is a conceptual difference that is not captured by the current proposed regulation. Besides, the calculation of short positions on indexes would be extremely difficult.

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

Given the evolving supervisory environment, we suggest the early discussion of the role of the new European Securities Authority replacing CESR to be co-recipient of the disclosed information, with the aim of making it the sole recipient in the long run, of all information.

This would not only make sense in the framework of the reform of the EU supervisory architecture, but also impose minor costs on market actors. This would be particularly true for those operating under several jurisdictions, who are those most hit by difference in reporting mechanisms and multiple channels.

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).

This does not necessarily add value and the cost on the market is already high enough. More information would be useless and too costly.

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

Yes. A real-time anonymous disclosure environment is technically feasible and also desirable from an informational perspective. However, we recognise there can be significant costs involved in such a regime, and that they have not been fully assessed at this stage.

[4] As already pointed out by the CFA Society of the UK in their response to the FSA. Available at : http://www.cfauk.org/assets/910/Short_selling_CFA_UK_response_May_8_2009.pdf

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?

We are seriously concerned that this may give raise to potential for abuse: market authorities do not possess the tools to know whether the market maker is acting as such or as a proprietary trader. We would like to know how CESR intends to enforce the exemptions for market makers, in particular when it comes to the difference between provision of liquidity to the market and proprietary trading.

Finally, following this reasoning, where the provision of liquidity is used as a benchmark, other market actors such as market neutral hedge funds would fall within the same exemptions.

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

See above.

Q17 Should CESR consider any other exemptions?

No.

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?

The lack of comparable powers among securities regulators within the EEA is one of the main reasons behind the lack of convergence and coordination observed in European markets when it comes to short selling regulation. There is a clear need to address this issue.

We hope a new pan-European short selling regime will be in place way before January 2011. However, provisions can be drafted bearing in mind the new powers of the European Securities and Markets Authority, which will have binding rule making powers and access to the data held by national authorities.

We believe that, in the meantime, a separate piece of legislation (outside the Market Abuse or the Transparency Directives) is the right way to address these issues. A regulation would of course be preferred, as long as it makes explicit reference to the new supervisory authority that should be in place within one year and a half.