CESR's Proposal for a Pan-European Short Selling Disclosure Regime – Deutsches Aktieninstitut's response

30 September 2009

I. Introduction

Deutsches Aktieninstitut[1] appreciates the opportunity to comment CESR's Proposal for a Pan-European Short Selling Disclosure regime.

Deutsches Aktieninstitut highly welcomes CESR's initiative and supports the analysis provided in the consultation paper. Improved transparency of short sales will clearly reduce both the danger of market abuses and the risk of disorderly markets. As stated in a previous comment paper[2] issuers are interested in a fair and harmonised regulation of short sales, as their shares may be shortened and possible abusive behaviour will revert to the issuer itself.

The two tier disclosure model that CESR proposes is unquestionable an improvement compared to the status quo and we encourage CESR to go ahead along these lines.

From the issuers' point of view CESR's suggestions need, however, be amended in some respects. In particular Deutsches Aktieninstitut suggests:

- to prohibit naked short sales as they are particularly prone to attempts of market abuse.
- to lower the public disclosure threshold to 0.1 percent, so that all market participants are provided with the same information at the same time.

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[1] Deutsches Aktieninstitut e.V. is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

[2] Possible regulation of short selling – Deutsches Aktieninstitut's considerations, 30 January 2009.

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- to report short sales on gross basis as a system based on a net calculation will be much more complicated and may offer ways to creatively circumvent the regulation.

II. General comments on CESR's analysis

CESR's analysis is well-balanced and covers most of the relevant issues with regard to short selling.

However, the analysis has to be completed by adding the negative consequences of abusive short selling for the respective issuers. For example, access to finance usually depends on the level of share prices. Therefore any pressure imposed upon share prices by short selling may worsen (re-) financing conditions even for companies which are basically solvent. These are two of the reasons why regulators imposed constraints on short selling during the financial crisis. Additionally, there is evidence that speculators massively shortened shares in order to achieve a company being excluded from a stock market index, which normally leads to a long-term loss of liquidity and a long-term fall of the price in the respective share at the expense of all other shareholders. And finally one should not forget that "irrational" (intra-day) stock price behaviour – which can often be linked to short sales – reverts to the issuer itself and its shareholders. Therefore, CESR should take into account the aspects of market integrity and efficiency as well as corporate governance aspects, i.e. shareholders' responsibility towards the company they invest in and towards all other shareholders of that company.

Furthermore, the proposal does not include a general ban of naked short sales which will be necessary to complement transparency rules. As naked short sales are not backed by a stock lending agreement there is no contractual or legal relationship between the lender and the borrower that could – at least indirectly – narrow the room for manipulative behaviour. Therefore, the danger of market manipulation is particularly virulent with naked short sales. Furthermore, naked short sales may lead to an over-supply of shares in the sense that the number of shares on the supply side of the stock market exceeds the number of shares economically available or even the number of shares that are booked into security accounts. This is why a number of countries introduced bans or strict regulations for naked short sales.

Therefore, Deutsches Aktieninstitut argues for a general ban of naked short sales and would like to encourage CESR to include this recommendation in its own analysis.

III. Comments on the questionnaire

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

Yes, CESR has the full support of Deutsches Aktieninstitut in enhancing transparency of short sales.

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

Basically, we agree with CESR's analysis.

However, CESR's suggestion does not fully capture one important intra-day issue. By selling shares short and subsequently floating rumours about an unsustainable overvaluation in the market one can extract enormous private profits from a later decline of share prices during a very short period of time, even within a view minutes. A transparency regime that only provides end-of day-position does not cover such transactions since these are typically closed by the end of the day.

Besides, the argument of implementation or compliance costs should not be overstressed, as the costs of abusive short sale activities (market abuses, disorderly markets, settlement disruptions, ...) may be much higher.

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

See answer to Q2.

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

We would not approve excluding foreign companies from the regulation as this would clearly lead to an unlevel playing field between companies for which the disclosure regime will not apply and EEA firms. Less disclosure requirements are translated to less costs and such a dual regime may have as a negative externality a shift in short selling activities towards unregulated entities.

In addition short selling activities outside the EEA in EEA listed companies' shares should principally also be covered as financial markets are global and there are close correlations between the prices of securities in different local markets. So we would like to encourage regulators to work on that subject.

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 alterna-

tive(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)?

Although Deutsches Aktieninstitut strongly welcomes CESR's transparency proposal as the two tier disclosure model is unquestionable an improvement compared to the status quo and we encourage CESR to go ahead along these lines, it is only a second best solution.

- We share CESR's point of view that there is no evidence that enhanced transparency will lead to a risk of short squeezes (paragraph 31.). Exactly the opposite is true. Transparency obligations for short sales would prevent extreme and unsustainable shortenings of certain shares and would therefore protect short sellers from being squeezed. The reason is that each potential short seller will be more cautious if there is already a high level of short sales in a respective share. As a result, the risk that an unsustainable level of short position could accumulate would be reduced.

- Consequently, while accepting the theoretical arguments in paragraph 32 we do believe that transparency on short sales will rather lead market participants to carefully evaluate whether there is an economic reason behind a short position or not and whether an additional short sale would lead to unsustainable risks for the short seller.

- We also would not support the argument "that some short sellers may not wish to trigger a public disclosure" as the leading principle of any regulation should be whether it is economically beneficial for the market as a whole and not for a single market participant.

For the reasons above we would be less cautious than CESR with regard to the disclosure thresholds and the information that is provided to the market.

From our point of view the system should provide all market participants with the same information as early as possible because all market participants should be protected from abuses and extreme price movements. They should have information on both the aggregate level of short sales and the identity of the short seller. Therefore, we would prefer public disclosure at the low threshold of 0.1 percent. This would not rise compliance costs for investors as CESR itself proposes the same threshold for private disclosure to the regulator.

At least, the public disclosure threshold should be lowered to at least 0.25 percent and regulators should provide the market participants with information on aggregate short positions on the basis of the lower private disclosure thresholds.

Last but not least the disclosure regime should take into account the possibility of "creative compliance". In particular, in calculating a threshold, positions of entities of the same group, or affiliated parties or of parties acting in concert should be aggregated. Otherwise, there would be much room for circumvention strategies.

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. CESR's carefully weights the arguments and comes to a convincing conclusion that the threshold should be calculated uniformally in the EEA.

Furthermore, we support that CESR's proposal does not prohibit complementing rules in member states. This option is particularly important, because there are a number of arguments to ban naked short sales in addition to transparency obligations.

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

No, we prefer a general public disclosure at 0.1 percent.

See answer to Q 5.

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?

As Deutsches Aktieninstitut prefers public disclosure at a lower threshold in general, there is no need for deviations in certain circumstances.

See answer to Q 5 and 7.

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

See answer to Q 5, 7 and 8.

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?

As Deutsches Aktieninstitut prefers public disclosure at a lower threshold in general, there is no need for deviations in certain circumstances.

See answer to Q 5 and 7.

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?

From Deutsches Aktieninstitut's point of view the success of any regulation strongly depends on the question how positions are calculated.

Deutsches Aktieninstitut shares CESR's analysis that short positions in all financial instruments and on all markets have to be included to provide the markets with information on the total short position. Additionally, it is important to aggregate position on the group level to prevent circumvention strategies as CESR proposes.

However, Deutsches Aktieninstitut opposes the suggestion to calculate positions on a net basis. This would complicate the system and would create the risk that transparency obligations will be circumvented by setting up different investment vehicles with different strategies in the same group. Furthermore, we do not believe that there are many cases of one single investor having short and long positions in the same share at the same time because there is no economic rationale for such a strategy. Therefore, short positions should be reported on a gross instead of on a net basis.

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

As an alternative to the disclosure to the authority of the most liquid market, disclosure to the issuer's home country authority could be discussed.

With regard to technical questions of making information available, Deutsches Aktieninstitut proposes a Pan-European register on short selling activities that can be accessed by both professional market participants and the general public. Alternatively and/or for a transition period each competent authority could have its own data base that will be linked up.

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).

From Deutsches Aktieninstitut's point of view it would be helpful to get information on the breakdown of the position as it makes a difference if the short position is purely synthetic or based on cash transactions.

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

Deutsches Aktieninstitut agrees, that information on short selling should be disclosed as soon as possible. As some short selling strategies are very short-term a real time disclosure could be helpful.

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.

Besides, it is important that even this exemption does not create a loophole for creative circumventions of the transparency regime. Therefore, Deutsches Aktieninstitut for example agrees with CESR's point of view that market makers should only be exempted from the regime if they act on a regular basis (paragraph 53 ii).

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

Yes.

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?

Yes.

However, CESR's proposal fails to address the question of sanctions. The effectiveness of any transparency regime rests on the possibility of regulators to impose sanctions on those who do not comply. For this reason, issuers can be fined or held liable if they do not inform investors correctly, for example. So, Deutsches Aktieninstitut encourages CESR to complement its proposal in this respect.

IV. Perspectives

CESR's proposal is an important step toward a harmonised regulation of short selling. Deutsches Aktieninstitut encourages CESR to go ahead along the lines proposed in the working document and to take into account the additional proposals we made above.

European harmonisation – while beneficial – should, however, only be the first step. As capital markets are global regulations should also be global. With respect to short selling it should be taken into account that it is possible to shorten the same stock in different local markets. In order to achieve market integrity it is important to know both the worldwide level of short sales and the short selling investors, at least principally.