

Short Selling Reporting Rules: A Greenfield Area
European Company Law Journal (forthcoming, 2015)
Elizabeth Howell*

Abstract

Short selling reporting obligations are helpful to regulators, particularly in deterring abusive behaviour. The EU Short Selling Regulation introduces common reporting requirements, however only some of these rules can be welcomed. Such issues become particularly evident when considering a recent ESMA report on the EU rules. Turning to the US, it has paid far less attention to short sale reporting obligations, however the SEC recently published a report analyzing the reporting proposals contained in the Dodd-Frank legislation.

This paper examines the approach taken to short sale reporting in the EU and US and discusses the recent reports. It suggests that changes are required in both jurisdictions to ensure reporting rules can be helpful rather than a hindrance.

* DPhil candidate in Law, University of Oxford (elizabeth.howell@law.ox.ac.uk). This research was supported financially by the Carnegie Trust. The author would like to thank Professor Jennifer Payne for her very helpful advice. Any errors are the responsibility of the author. For ease of reference a table containing some pertinent terms is attached as an appendix to this paper.

Short Selling Reporting Rules in the EU and the US: A Greenfield Area

Elizabeth Howell

1 Introduction

The European Short Selling Regulation (the ‘Regulation’)¹ came into force in November 2012. Of particular relevance to this paper are the Regulation’s reporting requirements applicable to shares. It opts for a two-tier approach, with notification to the regulator of individual net short positions (‘NSPs’) triggered at a particular threshold, and disclosure to the market commencing at a higher threshold. Although the private notification obligations can be broadly welcomed, the public disclosure rules raise concerns. Indeed, such issues become particularly evident when considering the Regulation’s recent evaluation, conducted by the European Securities and Markets Authority (‘ESMA Evaluation’).² However, despite this, the European Commission (the ‘Commission’) subsequently recommended no changes be made to the rules at present.³

In contrast the US has paid far less attention to reporting obligations: such provisions currently form only a small part of its regulatory framework. Further, those rules in place stem from a variety of sources and do not facilitate the efficient investigation of potential cases of market abuse by the Securities Exchange Commission (the ‘SEC’). Indeed when contrasted with the EU, no current data regularly provides the identities of short sellers to the SEC.

However the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 (the ‘Dodd-Frank’ Act) set out new proposals concerning short sale reporting, including a requirement for the SEC to conduct two studies in relation to short sale positions and transaction reporting. The SEC was required to report its results to Congress by July 2011, however it missed the deadline. The report was submitted in June 2014, and concluded that none of the options were likely to be cost effective.⁴ The SEC compared the proposals to a baseline of existing information plus data that would potentially be available following the creation of a comprehensive data repository for all information concerning orders and execution for exchange-listed securities and options (the Consolidated Audit Trail (‘CAT’)).⁵ Although this is to an extent a sensible conclusion, the CAT is still at an early stage and much will hinge on how it ultimately proceeds.

This paper examines the approach taken to short selling transparency obligations in the EU and US and discusses the recent ESMA and SEC reports. To an extent it is a somewhat technical discussion: although the EU rules are relatively clear, the current US rules are rather convoluted and fragmented in nature. Nonetheless this is an important discussion and the paper suggests the US has lessons to learn from the EU, especially in relation to the EU’s notification regime of individual short positions. Adopting such a requirement would

¹ Council Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1

² ESMA, ‘Technical Advice on the Evaluation of the Regulation (EU) 236/2012 of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps’ (June 2013).

³ European Commission, ‘Report from the Commission to the European Parliament and the Council on the Evaluation of the Regulation (EU) No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps’ (December 2013) 2-4.

⁴ SEC, ‘Short Sale Position and Transaction Reporting Report’ (5 June 2014).

⁵ SEC, ‘Consolidated Audit Trail, Release No. 34-67457 (Final Rule)’ (18 July 2012) 1.

particularly assist regulators in combating possible cases of market abuse: one of the SEC's particular concerns.⁶ However the EU should also take heed from the US, particularly concerning its development of the CAT. One of the biggest concerns in relation to the EU reporting obligations is the lack of harmonization of the reporting rules between regulators. With this in mind, the introduction of a centralized reporting system would be far more keeping with the Regulation's recitals that state the reporting obligations should be applied in a 'uniform' manner throughout the Union.⁷

2 Short Selling Concerns and Regulatory Tools

Three perceived concerns are often raised with respect to short selling: market destabilization, settlement risk, and market abuse. There are a number of regulatory tools that can be used with respect to these issues, including the imposition of short selling restrictions, adopting strict settlement obligations, and stipulating transparency requirements on market participants. These tools can be used separately or in some combination with one another.

Due to market destabilization concerns, short selling was the subject of short selling bans during the financial crisis. However, despite populist concerns that short selling can destabilize markets, short selling improves market efficiency: it contributes to efficient pricing, liquidity and leads to a more efficient price discovery process.⁸ Equally, restrictions generally make markets less efficient and there is little evidence that short selling constraints support prices and prevent price declines.⁹ Further, although 'naked' short selling¹⁰ can disrupt the market's orderly functioning if a seller is unable to deliver the shares to the buyer, it is not necessary to restrict short selling to tackle this concern. Imposing strict settlement periods with penalties for 'failures to deliver' should be sufficient to combat this.

Next, although short selling can be used abusively, it is not abusive per se. Indeed, as most jurisdictions have market manipulation regimes in place, such rules should be enforced more effectively to prevent any abusive behaviour occurring. Further, although public disclosure rules may help detect any abusive activity, such requirements can also deter short sellers from trading through the desire to avoid scrutiny, leading to a reduction in liquidity. Equally, other unsophisticated traders may follow the short seller's actions ('herding behaviour') reinforcing the price tendency and leading to the price spirals regulators are trying to prevent.

In contrast, requiring private notifications of individual NSPs can be helpful in tackling abusive behaviour without any of the downsides attached to public disclosure. However, such requirements should be limited to situations where, for instance, there is a perceived concern as to disorderly markets, or a high risk of market abuse occurring.

⁶ E.g. SEC, 'Amendments to Regulation SHO, Release No. 34-61595 (Final Rule)' (February 26, 2010) 1-2.

⁷ Regulation 236/2012, recital 3.

⁸ E.g. Edward M. Miller, 'Risk, Uncertainty, and Divergence of Opinion' (1977) 32 J Fin 1151.

⁹ E.g. Yang Bai, Eric Chang and Jiang Wang, 'Asset Prices under Short-Sales Constraints' (2006) Working Paper <http://web.mit.edu/wangj/www/pap/BCW_061112.pdf> accessed 10 December 2012.

¹⁰ I.e. where an investor sells shares without borrowing them in advance or making arrangements to ensure they can be borrowed.

3 The EU's Reporting Requirements

3.1 Two-Tier Regime

The Regulation introduces a two-tier private and public reporting regime at initial and incremental thresholds triggered by the size of an individual NSP. A person's NSP is defined as the position that remains after deducting any long position a person holds from any short position in relation to a company's issued share capital ('ISC').¹¹ A short position is defined as a short sale¹² of a share issued by a company, or entry into a transaction which creates or relates to a financial instrument other than the company share where the effect or one of the effects is to confer a financial advantage on the person entering into the transaction in the event of a decrease in the price or value of the share.¹³ The rules therefore encompass direct and indirect positions, including those created through the use of derivatives.¹⁴

Article 5: Private Notification

Article 5 provides that a person who has a NSP in relation to a company's ISC that has shares admitted to trading on a trading venue shall notify the relevant competent authority where the position reaches 0.2 per cent of the ISC and each 0.1 per cent increment above that (e.g. at 0.3 per cent and 0.4 per cent).¹⁵ A trading venue is defined as a regulated market or multilateral trading facility¹⁶ and the relevant competent authority is defined as the competent authority of the Member State where the share was first admitted to trading on a regulated market or trading venue.¹⁷

Article 6: Public Notification

Article 6 of the Regulation provides that a person who has a NSP shall disclose details of that position to the public where the position reaches 0.5 per cent of the ISC and each 0.1 per cent increment above that.¹⁸

Timing

The relevant time for the calculation of a NSP will be at midnight at the end of the trading day on which the person holds the relevant position, and the report is required to be made not later than at 15.30 on the following trading day.¹⁹

¹¹ Regulation 236/2012, art 3(4).

¹² Ibid art 2(b) defines a short sale.

¹³ Ibid, arts 3(1)(a)-(b). The concept of a long position is also correspondingly wide, see art 3(2).

¹⁴ Commission Delegated Regulation (EU) 918/2012 of 5 July 2012 supplementing Regulation (EU) No 236/2012 of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps with Regard to Definitions, the Calculation of Net Short Positions, Covered Sovereign Credit Default Swaps, Notification Thresholds, Liquidity Thresholds for Suspending Restrictions, Significant Falls in the Value of Financial Instruments and Adverse Events [2012] OJ 274/1, Annex I, Part 1 contains a list of financial instruments that constitute indirect long positions and can constitute indirect short positions (options, futures etc.).

¹⁵ Regulation 236/2012 arts 5(1)-(2). A notification must also be made if the position falls below the relevant threshold.

¹⁶ Ibid art 2(1)(l).

¹⁷ Ibid art 2(1)(j)(v).

¹⁸ Ibid arts 6(1)-(2). Disclosure must also be made if the position falls below the relevant threshold.

¹⁹ Ibid art 9(2).

3.1.1 Direct and Indirect Positions

As observed, to calculate a NSP, a person must net off any long and short positions it holds in relation to a company's ISC. The rules cover direct and indirect short positions, and Delegated Regulation 918/2012 provides that the calculation must take into account transactions in all financial instruments, whether on or outside a trading venue, that confer a financial advantage in the event of a change in price or value of the share.²⁰ This means the rules also encompass short positions accumulated over-the-counter ('OTC') provided that the NSP is created with respect to shares admitted to trading on a trading venue in the EU.²¹

Delegated Regulation 918/2012 also provides that holding a share through a long position in a basket of shares, and the short sale of a share through the short sale of a basket of shares shall also be taken into account to the extent the share is represented in the basket.²² Likewise, shares held indirectly by way of any index, or exchange-traded fund ('ETF')²³ or similar entity are also included, and positions shall be calculated taking into account the weight of that share in the basket, index or fund.²⁴

4 Comments

4.1 Private Notification

Notifying individual NSPs to regulators is valuable: it can provide early warning signs concerning the build up of, and who holds, a short position, enabling necessary follow up enquiries to then take place.²⁵ This can therefore help deter and constrain any particularly aggressive short selling that could be perceived to constitute a threat to the orderly functioning of markets.²⁶

However the Regulation's notification thresholds will be quickly crossed, especially by funds focusing on small market capitalization entities. As a result, there is a risk of overwhelming regulators with responses. Further, as the requirements are not restricted to financial sector firms, this could result in a lot of 'white noise' making it difficult for regulators to draw sensible conclusions from the data.²⁷ Market participants reiterated this to ESMA: some considered the thresholds to be too low,²⁸ and some perceived the increments to be too narrow and require more reporting than was useful.²⁹

²⁰ Delegated Regulation 918/2012, art 10(1)-(3).

²¹ Rodolphe Baptiste Elineau, 'Regulating Short Selling in Europe after the Crisis' (2012) 8 *International Law & Management Review* 61, 72. Delegated Regulation 918/2012 also sets out the method of calculation for a net position, providing that the 'delta-adjusted' model be used. For further details, see Appendix.

²² Delegated Regulation 918/2012, arts 5-6.

²³ For 'ETF' definition, see Appendix.

²⁴ Delegated Regulation 918/2012 Annex II, Part 1, art 10(3). See also art 3(3) of the Regulation.

²⁵ FSA, 'Short Selling Discussion Paper 09/1' (2009) 29.

²⁶ CESR, 'Report: Model for a Pan-European Short Selling Disclosure Regime' (March 2010) 5-6. Further, the decision to require notification of net rather than gross positions should be welcomed. Gross position reporting may not provide such an accurate picture or reflect the true market exposure.

²⁷ E.g. CFA, *CFA Society of the UK: Response to EC Public Consultation on Short Selling* (10 July 2010) 4.

²⁸ E.g. AIMA, *AIMA/MFA Response to the Call for Evidence by ESMA* (15 March 2013).

²⁹ E.g. Eumedion, *ESMA Call for Evidence* (15 March 2013) 2.

Consequently, although these requirements should be broadly welcomed, it would be preferable to limit their ambit. For example, the rules could be restricted to situations where there was a perceived risk of disorderly markets occurring, such as in relation to leading financial sector securities.³⁰ Further, the rules could also enable regulators to require notifications on a more ‘ad hoc’ basis to investigate cases of suspected market abuse.³¹ This would help enhanced the quality of the information being received while also reducing investors’ on-going costs.

4.2 Public Disclosure

Turning to the public reporting rules, such disclosures can provide information about the price movements short sellers expect and can improve the efficiency of price discovery, if correctly interpreted.³² However this needs to be carefully balanced against the serious drawbacks that may result from such disclosures.

First, as these requirements will identify short sellers, this may significantly reduce the overall level of short selling and will lead to lower trading volumes: a reduction in market liquidity.³³ This will stem from the extra costs to short sellers in having to disclose positions to the market, and through the cost to them in terms of competitive disadvantage in revealing their trading strategies.³⁴ Indeed, market participants highlighted to ESMA that there had been observed changes to trading behaviour in order to remain under the public threshold.³⁵ Further, public disclosure will also enable other market participants to act unfairly as ‘free riders’,³⁶ affecting the profits of those who conducted the research. This will reduce the incentives to conduct the research and will harm price discovery.³⁷

Next, public disclosure by an influential short seller may result in herding behaviour, whereby other poorly informed investors seek to profit by ‘jumping on the bandwagon’.³⁸ As this reinforces the price tendency, this risks exacerbating a downward spiral, exactly the effect the

³⁰ HFSB, *Consultation Response to the CESR Proposal for a Pan-European Short Selling Disclosure Regime* (2009) 4-5.

³¹ *Ibid* 4-5.

³² Commission, *Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on Short Selling and Certain Aspects of Credit Default Swaps COM (2010) 482*, 29-30.

³³ E.g. Oscar Bernal, Astrid Herinckx and Ariane Szafarz, ‘Which Short-Selling Regulation Is the Least Damaging to Market Efficiency? Evidence from Europe’ (2014) 37 *International Review of Law and Economics* 244 looked at fourteen jurisdictions in the EU where short sales took place and daily stock information was available between July 2008 - June 2009 and found that disclosure requirements reduced trading volumes and raised volatility.

³⁴ *Ibid* 246.

³⁵ ESMA (n 2) 12.

³⁶ A free rider benefits from a resource without having to pay for the cost of the benefit.

³⁷ Assosim, *European Commission Public Consultation on Short Selling* (July 2010) 2.

³⁸ Oskari Juurikkala, ‘Credit Default Swaps and the EU Short Selling Regulation: A Critical Analysis’ (2012) 9 *ECFR* 307, 318. Indeed, it may mislead the public as it can create the impression that a share price is declining when the position is simply a hedge, see Managed Funds Association, *Managed Funds Association Response to the European Commission's Proposals Relating to Short Selling* (July 2010) 5.

rules are seeking to prevent. Alternatively, market participants may suffer from others who exploit the information made available to manipulate prices to create a ‘short squeeze’.³⁹

Given the benefits short selling brings to markets, these issues should be of particular concern: lower trading activity will hamper price adjustments and affect the functioning of efficient markets. Indeed, due to the low thresholds and costs associated with public disclosure, short sellers may be unwilling to hold disclosable short positions. Instead they may seek other mechanisms to achieve their aim: for example they may choose to be less active in EU markets and migrate to more liberal markets rather than having their trading strategies undermined.⁴⁰ Based on the responses to ESMA, such concerns are not purely theoretical: changes observed have included the allocation of capital to markets outside Europe.⁴¹

This outcome, which cannot have been the intention of regulators, will clearly have a detrimental effect on EU markets relative to other markets. Thus although the Regulation stated that the requirements should address identified risks ‘without unduly detracting from the benefits that short selling provides to the quality and efficiency of markets’,⁴² it is evident that public disclosure obligations considerably detract from the benefits short selling provides.

4.3 De Minimis Threshold?

Turning to the inclusion of direct and indirect positions in the NSP calculation, this helps provides regulators with a more comprehensive picture and avoids any easy circumvention of the obligations. However, for short positions held indirectly through baskets, indices, or ETFs, given that such positions tend to be for hedging purposes rather than to express negative sentiment, it would perhaps be sensible to introduce a ‘de minimis’ threshold.⁴³ For example a position held in a security that represented part of a basket would only be included if the security had a minimum weight in the basket (e.g. of 20 per cent or more).⁴⁴

In its Evaluation, ESMA proposed some limited amendments however it was unwilling to consider introducing a de minimis regime. This is disappointing: such a system would likely produce more meaningful information for regulators, whilst alleviating the burden on market participants in terms of calculating such positions.

4.4 Harmonized Implementation?

In practice however, the greatest problem with the EU rules has been the lack of harmonized implementation between the regulators.⁴⁵ As each authority has implemented its own

³⁹ For ‘short squeeze’ definition, see Appendix.

⁴⁰ Such requirements could also become a de facto restriction on short selling above the public disclosure threshold, see AIMA, *CESR Consultation Paper on the Proposal for a Pan-European Short Selling Disclosure Regime* (2009) 10.

⁴¹ AIMA (n 28) 4-5; ESMA (n 2) 12.

⁴² Regulation 236/2012, recital 5.

⁴³ Eumedion (n 29) 3-4.

⁴⁴ ESMA, ‘Technical Advice on Possible Delegated Acts Concerning the Regulation on Short Selling and Certain Aspects of Credit Default Swaps ((EC) No 236/2012) Final Report ESMA 2012/263’ (April 2012) 70.

⁴⁵ AIMA (n 28) 1.

approach, this has resulted in multiple reporting channels and numerous differences in formats and communication methods. For instance the Belgian regulator requires the completion of a spreadsheet that includes a unique notification ID and also categorizes notifications by type (i.e. new position, updated position etc.).⁴⁶ The French regulator provides that an online access account must be created, the method of which varies depending on a person's status (for instance directors of listed companies can create accounts directly while persons holding disclosable NSPs must contact an administrator).⁴⁷ The Finnish regulator requires that reports must be made via protected email connection, and the British regulator provides that different email addresses should be used depending on whether it is a private or public report.⁴⁸

The lack of standardization creates significant operational burdens for market participants and is also contrary to the intention of achieving harmonized implementation. With this in mind, many market participants suggested creating a centralized reporting platform using a standardized format. This would be much more efficient and would also improve the quality of data being received.⁴⁹ For instance a single EU website could be used for publishing NSP disclosures, or ESMA could create a standard reporting form and specify a uniform communication method to be used by all national regulators.⁵⁰

Despite such issues, ESMA proposed no changes and appeared strongly swayed by regulators who preferred the current arrangements and believed the systems to now be operating smoothly.⁵¹ Such conclusions are again disappointing: the lack of harmonization is the antithesis to what the Regulation seeks to achieve. A centralized reporting platform and standardized reporting methods would be far more in keeping with its recitals that stated the reporting obligations were to be applied in a uniform manner throughout the EU.⁵²

4.5 Concluding Comments

In the Commission report that stemmed from ESMA's Evaluation, it chose not to tackle the concerns that have arisen in practice. The Commission stated that there was no need to change the methods for calculating NSPs, observed that the current system was 'functioning well' and stated that a centralized system did not appear to offer substantial benefits.⁵³ The Commission's unwillingness to address concerns, or to consider ESMA's minor amendments is unhelpful. Indeed it is hard to agree with the view that the current set-up is functioning

⁴⁶ Belgian Financial Services and Markets Authority, 'Short Selling' (2014) <<http://perma.cc/L254-3H4R>> accessed 25 November 2014; AIMA (n 28) 6-7.

⁴⁷ Autorité des Marchés Financiers, (2014) <<http://perma.cc/LJ7H-6DZD>> accessed 25 November 2014.

⁴⁸ Finnish Financial Supervisory Authority, 'Notification of Short Positions' (2014) <<http://perma.cc/NNQ2-5PYJ>> accessed 25 November 2014; UK Financial Conduct Authority, 'Short Selling' (2014) <<http://perma.cc/W3UB-KHMD>> accessed 25 November 2014.

⁴⁹ Societe Generale, *Response to the ESMA Call for Evidence* (March 2013) 2.

⁵⁰ AIMA (n 28) 6.

⁵¹ ESMA (n 2) 19.

⁵² Regulation 236/2012, recital 3.

⁵³ European Commission, 'Report from the Commission to the European Parliament and the Council on the Evaluation of the Regulation (EU) No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps' (n 3) 2-4.

well. The lack of harmonization between regulators results in operational difficulties, confusion, and creates a risk for data quality.⁵⁴

5 US Transparency Requirements

Moving across the Atlantic, the main difference with the EU is the absence of an individualized reporting obligation in the US. Instead, the US rules include marking requirements and a variety of more general reporting obligations. Recently, there has also been an increase in publicly available short selling information, and Dodd-Frank has now introduced further proposals.

5.1 Marking and Reporting Requirements

Order Marking

Rule 200 of Regulation SHO sets out reporting requirements for sales of all equity securities. Rule 200(g) provides that a broker or dealer must mark all sell orders as ‘long’, ‘short’ or ‘short exempt’.⁵⁵ Under rule 200(g)(1) an order to sell shall be marked long only if the seller is deemed to own the security pursuant to rule 200 and either the security is in the broker-dealer’s physical possession or control, or it is reasonably expected that the security will be in their physical possession or control no later than settlement. This limits the possibility of marking an order long as a person may be deemed to own the security being sold but possession, control or the reasonable expectation thereof in time for settlement may not be present.⁵⁶ Further, SEC guidance currently also errs on the side of marking orders short.⁵⁷

Audit Trails

In the US, securities exchanges, securities associations (such as FINRA⁵⁸), and clearing agencies are all classified as self-regulatory organizations (‘SROs’) and maintain their own audit trails for their members. Specifically, FINRA imposes its own order recording and reporting requirements under its order audit trail system (‘OATS’).⁵⁹ These rules impose obligations on FINRA member firms to report order information to FINRA on a daily basis.⁶⁰ Initially, the rules only applied to equity securities listed on the Nasdaq Stock Market (‘Nasdaq’) and to OTC equity securities, however the rules were expanded to cover all national market system (‘NMS’)⁶¹ stocks during 2011. To avoid duplicate reporting, the New York Stock Exchange (‘NYSE’) and NYSE Arca replaced their requirements for members

⁵⁴ ESMA (n 2) 19.

⁵⁵ For further details on the ‘short exempt’ marking, see Appendix.

⁵⁶ E.g. a person may be deemed to own the securities but there may be transfer restrictions meaning the seller cannot meet the possession or control requirements.

⁵⁷ SEC, ‘FAQs on Regulation SHO’ (2012) Question 2.5
<<http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm> (<http://perma.cc/VFP2-F4MN>)>
accessed 9 June 2014.

⁵⁸ FINRA, created in 2007, was designed as a monopoly SRO under the SEC’s oversight.

⁵⁹ FINRA rules 7410-7470.

⁶⁰ SEC, ‘Order Approving a Proposed Rule Change, Release No. 34-63311’ (12 November 2010). For short sale orders, the broker will record the order’s designation as short and report this to FINRA.

⁶¹ A ‘NMS stock’ is defined in rule 600(b)(47) Regulation NMS. For further details, see Appendix.

who were members of FINRA or Nasdaq with rules allowing them to satisfy their obligations by meeting the OATS requirements.⁶²

Trade Reporting

Once an order is executed, a report is submitted to either the exchange or to FINRA if executed OTC. This includes identification as to whether the transaction is a short or long sale.⁶³ Separately, the SEC can also request that a broker-dealer firm submits information including whether a transaction was a purchase, sale, or short sale ('electronic blue sheet' ('EBS') submissions). This helps assist the SEC with investigations of federal securities violations by identifying buyers and sellers of particular securities.⁶⁴

Large Traders

Separately, 'large traders'⁶⁵ are now required to register and receive an identification number from the SEC.⁶⁶ This number allows large traders' activities to be aggregated across multiple broker-dealers and provides the SEC with a faster way to acquire information, including relating to short selling activity.⁶⁷ Upon request the SEC can also require broker-dealers to report transaction information including the time of execution for any trade involving a large trader.

5.2 Consolidated Audit Trail

All these requirements provide mechanisms for capturing information concerning short sale orders and trade reports. Despite this, the rules do not produce a complete audit trail and suffer from deficiencies including levels of accuracy, completeness and timeliness.⁶⁸ It has already been observed that marking short sale orders can be fairly complex and that there is a tendency to err on marking orders short.⁶⁹ Likewise, the OATS information will not include activity occurring at exchanges or broker-dealers that are not FINRA or Nasdaq members.⁷⁰ Further, an investigation involving short sellers could involve a rather cumbersome process including gathering data from SROs, information requests via EBS reports, plus obtaining large trader information from broker-dealers.⁷¹

Essentially, the existing regulatory data infrastructure is inadequate and ineffective to oversee widely dispersed trading across a variety of market centres.⁷² Indeed, the SEC has stated that

⁶² SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 5) 27.

⁶³ SIFMA, 'Short Sale Reporting Study' (23 June 2011) 3.

⁶⁴ SEC, 'Electronic Submission of Securities Transaction Information, Release No. 34-44494' (29 June 2001).

⁶⁵ 'Large trader' is defined in rule 13h-1(a)(1)(i) Exchange Act. For further details, see Appendix.

⁶⁶ SEC, 'Large Trader Reporting, Release 34-64976' (27 July 2011).

⁶⁷ SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 25.

⁶⁸ SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 5) 27-28.

⁶⁹ SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 21-22.

⁷⁰ SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 5) 28.

⁷¹ SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 29.

⁷² SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 5) 4.

regulators have to ‘cobble together disparate data from a variety of existing information systems lacking in completeness, accuracy, accessibility and/or timeliness’.⁷³

With this in mind in 2012 the SEC required the SROs to submit a plan governing the creation and implementation of the CAT for exchange listed securities and options.⁷⁴ As observed in section 1, this will result in a comprehensive data repository for all information concerning orders and execution.⁷⁵ The plan was submitted to the SEC in September 2014 and is now subject to its review. It is estimated it could take at least three to five years before it is implemented.⁷⁶

If the plan is approved, this should considerably improve market oversight, enabling regulators to have access to information on all orders to trade NMS securities in a single system, including the security type, size, short sale order mark, and customer identity.⁷⁷ With the data, the SEC and SROs will be able to run processes to quickly identify the activity of large short sellers.⁷⁸ Thus, as will be explored further at section 5.3 below, although it has some limitations, the CAT’s implementation should considerably improve regulators’ access to useful short selling information.⁷⁹

5.2.1 Public Disclosure: SROs

In July 2009, the SEC announced that instead of renewing emergency short selling rules it had adopted during the crisis, it was working with the SROs to increase the public availability of short selling related information. First, the SROs would commence daily publication of aggregate ‘short sale volume’ information in each equity security for that day.⁸⁰ Further, on a one month delayed basis, SROs would also publish information regarding individual short sale transactions in all exchange-listed equity securities.⁸¹ Informal guidance indicated that

⁷³ Ibid 6.

⁷⁴ Ibid 1.

⁷⁵ Securities Industry and Financial Markets Association and Davis Polk, ‘Current Market Structure Issues in the U.S. Equity and Options Markets’ (US Equity Market Structure Conference, 17 October 2013) 26.

⁷⁶ Note that in October 2014, FINRA announced its own initiative to implement a comprehensive automated risk data system initiative (‘CARDS’). This would require FINRA members to submit extensive data to FINRA on a monthly basis. Concerns are already being raised as to duplication and whether this proposal is necessary on top of the CAT initiative, see e.g. Davis Polk, ‘FINRA Proposes New “CARDS” Data Collection System’ (30 October 2014).

⁷⁷ SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 4) 24. The information is also required to be reported by 8 am on the trading day following the day on which the information is recorded.

⁷⁸ See *ibid* 24.

⁷⁹ Indeed, once implemented the CAT will be the world’s largest repository of securities transactions. It is estimated that it will receive approximately 58 billion records on a daily basis, see e.g. ‘Summary of the Consolidated Audit Trail Initiative’ (2014) <<http://catnmsplan.com/web/groups/catnms/@catnms/documents/appsupportdocs/p571933.pdf>> accessed 11 November 2014.

⁸⁰ SEC, ‘Increasing Transparency around Short Sales’ (2009) 3 <<http://www.sec.gov/news/press/2009/2009-172.htm> (<http://perma.cc/5TNB-4NDG>)> accessed 2 June 2014. Short selling volume was defined as the volume of executed orders marked short (or short exempt following the introduction of the alternative uptick rule).

⁸¹ *Ibid* 3. The SEC would also publish data twice monthly on fails to deliver for all equity securities regardless of the fail levels.

individual investor identification was not being contemplated.⁸² Rather the information is anonymised and contains data including the transaction date, the symbol, price, and number of shares for every transaction.⁸³

Despite the increase in publicly available data, market participants do not appear to widely monitor or use the information available.⁸⁴ This suggests that issuers and investors do not use such data to try and detect any abusive shorting activity; rather they rely on the regulators to monitor for potentially manipulative behaviour.

5.3 Dodd-Frank

5.3.1 Section 417(a)(2)(A): Real-Time Short Position Reporting

Turning to the Dodd-Frank proposals, section 417(a)(2) required the SEC to conduct two studies in relation to short sale position and transaction reporting.⁸⁵ Examining section 417(a)(2)(A), this required the SEC to conduct a study of the feasibility, benefits, and costs of requiring reporting publicly, in real-time, short sale positions of publicly listed securities, or alternatively only reporting these to the SEC and FINRA.

Public Disclosure

First, considering real-time disclosure that would publicly identify short sellers, although this would provide market participants with new information that they cannot infer from existing information,⁸⁶ the drawbacks observed in relation to the EU's public disclosure regime remain prominent. For instance, due to concerns about revealing their trading strategies, short sellers may curtail their activities, which would have a harmful effect on price efficiency.⁸⁷ Equally, investors could misunderstand the information: indeed given the volume of information that would be released, most market participants would be unable to directly analyze the data.⁸⁸ Further, real-time reporting would also require an entirely new infrastructure and the on-going costs of compliance could also be significant.⁸⁹

Reporting to the Regulators

Turning to reporting that would only identify short sellers to the SEC and FINRA, this would clearly help in detecting and bringing actions relating to manipulation, particularly if indirect positions were also included.⁹⁰ However, this option would entail the same costs of

⁸² Schulte, Roth and Zabel, 'SEC to Increase Public Disclosure of Short-Selling' (29 July 2009).

⁸³ Separately, FINRA publishes total short interest data of FINRA member firms twice a month.

⁸⁴ SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 19.

⁸⁵ Section 929X(a) of Dodd Frank also provided that short sale disclosure would be required of institutional investment managers on at least a monthly basis. The SEC is still to adopt rules in relation to this section however the general expectation is that this information will be released publicly on an aggregate basis. For a definition of 'institutional investment manager', see Appendix.

⁸⁶ SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 73.

⁸⁷ Ibid 80.

⁸⁸ The SEC estimated there could be approximately 24 million short position changes per day.

⁸⁹ SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 86.

⁹⁰ Ibid 111.

implementation and compliance as a public regime, and the SEC considered that the benefits would only be modest when taking account of the CAT.⁹¹

Aggregate and Anonymous Disclosure

A further option proposed public reporting of aggregate, non-identified short positions.⁹² Although this could help investors gauge market sentiment in real-time, it would provide little benefit with respect to detecting abuse.⁹³ Further, many of the limitations already highlighted would also remain: the data would be cumbersome to work with and there would be high compliance costs. Indeed, these costs could be higher due to the additional step of having to aggregate the data before disclosing it.

Essentially, the SEC concluded that the benefits of real-time reporting were likely to be modest, and the costs would likely be significant.⁹⁴ This was especially so when considering the data that would be available once the CAT was implemented. However, as already observed, although the CAT will undoubtedly bring much needed improvements, its value will initially be curtailed by its limited coverage.

5.3.2 Section 417(a)(2)(B): Short Sale Transaction Data

Section 417(a)(2)(B) also provided that the SEC should conduct a study into the feasibility, benefits, and costs of conducting a voluntary pilot in which public companies agreed to have trades of their shares marked ‘short’, ‘market maker short’, ‘buy’, ‘buy to cover’ or ‘long’ and reported in real-time through the Consolidated Tape (the system that reports transaction information for listed securities and ETFs).⁹⁵ The SEC concluded that the most feasible way to report transaction marks to the Consolidated Tape would be to populate the marks with information from the order marks, reflecting the investor’s position at the time of the order entry rather than the point of execution.⁹⁶ As already observed, this could again lead to over-estimations as to the number of short trades taking place.⁹⁷

Real-time availability of these transaction marks would increase the comprehensiveness and precision of the data market participants would obtain.⁹⁸ It would also provide new information on real-time market sentiment and could discourage abusive short selling, especially if it enhanced surveillance. However the benefits to regulators would again only be modest once the CAT was factored in. Likewise, although non-regulators could use the data to monitor for abusive behaviour, it has already been observed that issuers do not use, and in some cases are not even aware of, existing public data.⁹⁹ Further, misinterpretation of the marks could result in poor trading decisions, and there would be potential for mismarking.¹⁰⁰

⁹¹ Ibid 109.

⁹² Ibid 93.

⁹³ Ibid 95-96.

⁹⁴ Ibid 115.

⁹⁵ Under current rules, order marks are not reported to the Consolidated Tape but are maintained as part of the broker-dealer’s records. For further details on the Consolidated Tape, see Appendix.

⁹⁶ SEC, ‘Short Sale Position and Transaction Reporting Report’ (n 4) 35.

⁹⁷ Ibid 36.

⁹⁸ Ibid 38.

⁹⁹ Ibid 49-50.

¹⁰⁰ Ibid 44.

The sheer volume of the data would also limit its value,¹⁰¹ and it would be expensive to add the marks with hundreds of market participants having to update their systems.¹⁰²

Ultimately, as this information was already broadly captured under existing requirements, and was also available to the regulator, the SEC concluded that adding transaction marks would have little additional regulatory benefit particularly once the CAT was in place.¹⁰³

6 Comments: US Rules

Short sale reporting requirements currently form only a relatively small part of the US's regulatory landscape. Further, the systems that are in place, at least prior to the CAT's implementation, are somewhat fragmented. No data regularly provides the identities of short sellers to the regulator, and the available information can over-estimate the number of those establishing or increasing a short position. Next, to the extent that public information is disclosed, it is under-utilized. It is disappointing that less emphasis is placed on the importance of reporting in the US given that one of the SEC's particular concerns is to monitor for abusive behaviour and given that such requirements could provide it with a useful tool in this regard.

Despite this, it is also clear that the CAT will result in considerable improvements and its development should be welcomed. However, the project is still in its early stages with many difficult decisions being delegated to the SROs, so it remains to be seen what will materialize going forward. Likewise, it is also clear that the CAT will overlap with some of the existing reporting requirements. This is worth bearing in mind: the current regime is already rather murky and it would be helpful for duplicative rules to be eliminated for clarity.

7 Lessons to be learned?

It is important to remember what is valuable about reporting requirements and in this regard a number of clear statements can be made. First, the primary objective of a short selling reporting regime should be to deter market abuse, and regulatory commitments to fairness and transparency do not equate to granting investors and participants a free ride on others' proprietary information or investment strategies.¹⁰⁴ Next, individual short position notifications are helpful to regulators in combating potentially abusive behaviour. Further, encompassing direct and indirect positions is crucial: it demonstrates a level of sophistication and prevents easy circumvention of the rules. Despite this, it is also sensible to restrict the ambit of notification requirements to situations where there is a high risk of abuse. Next, public disclosure obligations are unhelpful and can be detrimental to market efficiency. Finally, implementing a centralized set of rules is vital.

The EU's approach can be welcomed in as far as it supports confidential reporting of direct and indirect NSPs to regulators. However the regime fails to strike the correct balance: it applies permanently, the thresholds are too low, and there are serious concerns in relation to public disclosure. Indeed the evidence from the EU suggests that short sellers are avoiding

¹⁰¹ The SEC estimated there could initially be 23 million transaction reports per day on the Consolidated Tape.

¹⁰² SEC, 'Short Sale Position and Transaction Reporting Report' (n 4) 37. Moreover, pilots are subject to various limitations, for instance market participants knowing a pilot is underway may not act as they would under a permanent regime. See *ibid* 64-65.

¹⁰³ NYSE Euronext, 'Testimony of Joseph Mecane' (Short Sale Roundtable, 30 September 2009) 2.

¹⁰⁴ World Federation of Exchanges, 'Public Comment on Regulation of Short Selling' (7 May 2009) 2.

crossing the public threshold and are moving capital elsewhere, and this cannot have been the regulators' intention. In this regard the EU should look to the US: for all its other complexities, the absence of individual public disclosure requirements in the US is sensible. Likewise, the EU reporting systems currently suffer from an ironic lack of harmonization. With this in mind it should pay close attention to the CAT's development: a centralized system would be far more in keeping with the vision of harmonized reporting rules.

Turning to the US, a multitude of different rules exist: some imposed by statute, others by SROs, some that are general, others that relate specifically to short selling. Likewise, the current US framework also makes it challenging for the SEC to effectively investigate cases of potential manipulation. Regulators are required to 'cobble together' many sources of information lacking in timeliness, accuracy and accessibility: a model that does not result in a complete and accurate set of data.¹⁰⁵ Although the CAT should eventually bring improvements, the project is still in its infancy. Ultimately, until the US follows the EU's lead in requiring individual NSP reporting to the regulator, any system will be of limited use to it.

8 Conclusion

There is currently little consistency in the approach taken in the EU and the US to short sale reporting obligations, and supranational harmonization remains a distant aspiration. Further, at present there is not even consistency between the regulators' implementation of reporting rules within the EU. This is disappointing: harmonization both within and between jurisdictions is vital in today's international markets in order to prevent confusion and to avoid additional challenges and costs for market participants.

Looking to the future, both jurisdictions should pay heed to the words of IOSCO that noted that short selling reporting was a 'greenfield' area and that regulators would have limited experience.¹⁰⁶ With this in mind, the EU and US should acknowledge they have not yet found the correct balance with their choice of transparency regimes and contemplate what changes may now be required. Lessons should be learned on both sides of the Atlantic to ensure that short selling reporting obligations can be helpful rather than a hindrance.

¹⁰⁵ SEC, 'Consolidated Audit Trail, Release No. 34-67457 (Final Rule)' (n 5) 6.

¹⁰⁶ IOSCO, 'Regulation of Short Selling, Final Report' (June 2009) 14.

Appendix

Term	Definition
Baskets of Securities	A group of securities that are treated as a single unit and traded together.
Consolidated Tape	<p>The Consolidated Tape comprises of Tapes A and B of the Consolidated Tape Plan and Tape C of the Unlisted Trading Privileges ('UTP') Plan.</p> <p>Trades in NYSE-listed securities are reported to Tape A; trades in NYSE-Amex, NYSE-Arca, and regional exchange listed securities are reported to Tape B; and trades in Nasdaq listed securities are reported to Tape C.</p>
Delta-Adjusted Model	<p>'Delta' indicates how much a financial instrument's theoretical value is expected to move in case of an underlying instrument's price variation. For example a stock option with options delta of 0.8 would be expected to rise £0.80 with a £1 rise in the underlying stock.</p> <p>EU Delegated Regulation 918/2012, Annex II provides that derivative and cash positions (i.e. direct short positions in a stock) shall be accounted for on a delta-adjusted basis with cash positions having delta 1.</p>
Exchange Traded Fund ('ETF')	An ETF holds a portfolio of securities or derivatives and aims to track and replicate the performance of an index, a commodity, or basket of assets. ETFs trade on the stock exchange.
Institutional Investment Manager	Sections 3(a)(9) and 13(f)(6) Exchange Act defines an institutional investment manager as a person investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.
Large Trader	Broadly, this relates to a person whose transactions in NMS securities equals or exceeds 2 million shares or \$20 million during any calendar day, or 20 million shares of \$200 million during any calendar month.
NMS Securities	NMS securities broadly refer to exchange listed securities and standardized options.

NMS Stocks	NMS stocks broadly refer to exchange listed securities other than options.
‘Short Exempt’ Order Marking	Marking an order as ‘short exempt’ reflects the reintroduction of a type of price test in the US in 2010 (i.e. the ‘alternative uptick rule’). Rule 200(g)(2) of Regulation SHO provides that after the 10 per cent circuit breaker is triggered for a security, a sale order is permitted to be marked short exempt if the broker-dealer identifies the order as being at a price above the national best bid at the time of submission.
Short Position	<p>Direct Short Position: a short position taken in the stock itself (also known as a ‘cash position’).</p> <p>Indirect Short Position: Other types of economic exposure to the stock e.g. through the use of derivatives.</p> <p>Net Short Position (‘NSP’): The position that remains after deducting any long position a person holds from any short position a person holds in relation to a company’s issued share capital.</p>
Short Squeeze	If share prices rise quickly and are sustained for a period then short sellers can be caught in a short squeeze with covering short positions driving prices up further. This can result in substantial losses and can lead to increased volatility.