A GLOBAL GUIDE TO SHORT-SELLING REGULATIONS

European regulators are fining managers who fail to report short positions in a timely manner, while other regulators from Greece to China are cracking down on short-selling as markets flounder. *HFMWeek* takes a look at the rules governing the practice in various jurisdictions

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EUROPE

The EU introduced tough new short-selling regulations during the financial crisis when many policymakers blamed short sellers for exasperating stock market falls.

The rules came into force on 1 November 2012 with the aim of increasing transparency on trades, reducing risk and creating new powers to intervene.

Significantly, Esma has the power to directly ban short-selling in 'exceptional circumstances' in any EU country. The UK challenged the short-selling rules in court but they were dismissed by the European Court of Justice.

The latest example is Greece where Esma has banned short selling, although the Athens stock exchange has been suspended since Friday 26 June.

The 2012 rules created new reporting requirements, meaning firms must report trades of 0.2% of company-issued share capital and every 0.1% above that to national regulators.

In addition they must publicly disclose any position that is 0.5% of company issued share capital and every 0.1% above that.

Hedge funds have already fallen foul of the rules and European regulators have begun to crackdown with some high profile scalps.

In April, AQR Capital Management was fined €500,000 ($568,000) from the Dutch regulator for missing a deadline to report two short positions taken in Dutch issuers. In May, Finnish regulator the FSA fined London-based hedge fund Noster Capital €15,000 ($16,475) for late reporting.

Regulatory consultants lament the lack of "common standard" on fines handed out in Europe on short reporting.

"The reporting rules make company access slightly harder if you have positions above the disclosure limits because management may be unwilling to speak to you if you are short [their stock]," says Selvan Masil, CIO at Westray Capital Management, a $30m long/short equity manager focused on Europe.

ASIA

Short-selling is permitted in Singapore, Philippines, Thailand, Taiwan, Japan, India, Hong Kong and China with various limitations. It is not permitted at all in Vietnam and Sri Lanka.

China only allowed short-selling for domestic investors in 2008 and only began to allow foreign investors to short last year under the Hong Kong/Shanghai Connect programme.

Under Connect, foreign investors are permitted to borrow certain A Shares listed on the Shanghai stock exchange to affect covered short-sale transactions.

But China has also shown its displeasure with short-sellers by effectively banning them in the last month during a stock market rout that began in early June. Chinese regulators are investigating short-selling actions on markets and have indirectly contacted firms through exchanges to stop firms shorting stocks.

Lawyers say there are echoes of the European response to the financial crisis when London banned shorting. Experts say the bans could damage foreign investment in China.

"There are a wide variety of jurisdictions in Asia with complete bans to more open processes," says Derek McGibney, director of Cordium Asia. "It is a general issue with Asian markets that you have a lot of countries with diverse requirements and legal frameworks. While general regulation is coming from global bodies, the cost of compliance needs to be incorporated into your local business strategy.

"We would advise that anyone going into a new jurisdiction seek direct local advice and access to technical detail, because such rules are subject to change. There is a commercial element of having that information available immediately."

McGibney says knowing local short-selling rules is now a trading issue and not just a compliance matter.

"The wrong way to do it is to start trading because of a lucrative market opportunity and then work backwards in looking into the regulatory implications," he says. "You need compliance knowledge in the front office and to consider risks and costs of a decision to trade in a particular market."

UNITED STATES

Short-selling in the US is governed by Regulation SHO. First introduced in 2004 and amended since, the regulations include requirements around trade identification (long, short or short exempt), preventing short-sale execution or display at an "impermissible price" (when a stock experiences a price decline of at least 10% in a day), ensuring broker-dealers are able to locate stocks to ensure deliverability and the close-out of positions not delivered.

While hedge funds are required to report portfolio information for various purposes, these don't include short interest reporting, either of the fund or manager, notes Elliott Curzon, a US-based partner at Dechert.

Curzon notes the Dodd-Frank Act required the SEC to conduct a study on short position and transaction reporting, particularly to consider real time reporting. "[A] pilot programme was implemented but [regulators concluded] it didn't provide any additional useful information other than what was already available through consolidated audit trails.

"[They found] collecting real-time data might deter certain abusive shorting [practices] but it could also provide front-running opportunities and the associated implementation costs would outweigh any benefits," Curzon says, adding the SEC is still deciding whether to implement any short sale reporting requirements but that there isn't much "urgency" towards further action.

CANADA

Governed by provincial and country-wide regulations, most of Canada's short-selling rules apply to broker-dealers instead of managers, Sarah Gardiner, partner at Borden Ladner Gervais, explains.

Within Ontario, which has one of the biggest securities markets in the country, one of the Ontario Securities Act's only requirements relating to managers is that when placing an order for the sale of a security through a dealer, managers must declare to the dealer if they don't own the security.

"Managers that fail to disclose the relevant information can face significant fines or imprisonment, or both," Gardiner says.

She also notes Canada has national principles-based anti-fraud regulations which provide that no person or company can engage in any activity if they know or ought reasonably to know that the activity will result in or contribute to a misleading appearance of trading activity in, or artificial price, of a security, or perpetrate a fraud on any person or company.

For dealers, shorting laws relaxed slightly in 2012 when Canada, following the US, repealed a tick test provision that prohibited short sales unless they were at or above the last sale price for that security, with the Investment Industry Regulatory Organization of Canada's studies demonstrating the rule didn't impact price movements.

BRAZIL

Short-selling in Brazil isn't heavily regulated although the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários – CVM) does place restrictions on the practice in relation to stock offerings, explains Luiz Roberto de Assis, partner at São Paolo-based law firm Levy & Salomão Advogados.

"The most recent changes made by CVM were in 2012 when they issued an instruction prohibiting investors from purchasing shares in a stock offering if they have shorted those shares within five business days of the offering being priced," he says.

Brazil controls stock lending in its securities market through the Brazilian Clearing and Custody Corporation (CBLC), the clearing house for Bovespa, the São Paulo Stock Exchange, he adds.

"All transactions are centralised and if someone sells shares they don't own and fails to deliver them, there is an automatic mechanism [to deal with that]," he says, explaining the seller – whether a hedge fund or other market participant – would be forced to borrow the shares from the CBLC and if they weren't available, would face a fine of 0.2% of the transaction value per day until the shares were delivered.

Failure to communicate the acquisition or disposal of shares representing 5% or more of a publicly-traded company is defined as a 'serious infringement' which can incur penalties such as a temporary ban on activities requiring CVM authorisation, in addition to a fine.

SWITZERLAND

Unlike the European regime, Swiss law doesn't have specific provisions around short-selling and prior to the collapse of Lehman Brothers, naked shorting was not expressly prohibited, Jacques Iffland, partner at Lenz & Staehelin, explains.

"When Lehman collapsed, the Swiss regulator issued a notice to regulated firms essentially saying that everyone should be aware that naked short-selling was prohibited," he says, adding that it "came from nowhere".

"Since 2008 it has become clear that you must have a legal arrangement in place that guarantees when you execute a trade you will be able to deliver those securities."

Following the regulator's notice the Swiss stock exchanges also introduced rules prohibiting naked shorting for all participants.

While not explicitly targeting short selling, the Swiss Stock Exchange Act requires that anyone reaching or exceeding certain ownership thresholds (of 3%, 5%, 10%, 15%, 20%, 25%, 33%, 50% or 66%) in Swiss-listed companies notifies the company and the relevant exchange.

"Investors must account for their long and short positions to determine whether a threshold has been crossed, and if it has through the use of derivatives, it must be disclosed," Iffland says.

"And regardless of how you cross a threshold [long or short], you then have to report all your portfolio positions, providing relatively detailed information about your short derivatives such as the issuer, duration and strike."

Iffland adds that failing to disclose reaching or exceeding a threshold within four trading days is a criminal matter incurring a financial penalty.

Voluntary failure, where someone knowingly or recklessly disregards the obligation, can lead to a fine of up to CHF10m ($10.5m) while negligence, where someone didn't undertake proper due diligence to make themselves aware of the obligation, can incur a fine of up to CHF1m ($1.1m). ■

NAKED SHORT-SELLING

Naked short-selling, where stock delivery fails as the seller has not borrowed the securities in time, is prohibited in the US under Regulation SHO where the failure to deliver was deliberate – to distort the price of a security or avoid paying borrowing costs. But a recent case being heard by the Supreme Court has raised questions of whether state anti-fraud provisions can supersede federal law, Dechert's Curzon notes.

In Merrill Lynch, Pierce, Fenner & Smith v Greg Manning, shareholders of Escala Group common stock have alleged the defendants, which include Merrill Lynch and Citadel, engaged in illegally naked shorting of Escala stock, causing Escala's tradable shares to increase by "electronically manufacturing fictitious and unauthorised phantom shares", diluting the shareholders' voting rights and causing their shares to decline in value.

The shareholders based their claim on alleged violations of the New Jersey Racketeer Influenced and Corrupt Organization Act and wanted the action held in state court, while the defendants moved the action to New Jersey's district court (a federal court).

"The parties have submitted a petition for the Supreme Court to decide whether Section 27 of the Securities Exchange Act of 1934 provides federal jurisdiction over state law claims and whether or not the naked short selling at issue violates state law," Curzon explains.