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FINANCE & BANKING ALERT

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UPDATE: NO MORE SILENT BIG SHORT POSITIONS

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Background

Following the 2008 global financial crisis, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) created a Task Force to identify gaps in the regulation of short sales. The Task Force recommended four principles that sought to protect the benefits of short selling, whilst simultaneously trying to reduce the potential risks of short selling, such as the destabilising effect it can have when used in an abusive manner.

The FSCA's proposal

The FSCA, in an attempt to bring the four principles into the South African market, has proposed that South Africa adopt two separate models of reporting and disclosure, which will be utilised in tandem.

The first is the transactional reporting or the flagging of short sales model. Under this framework, the individual short sales are 'flagged' or 'marked' by the authorised users on the exchange. This enables the exchange to know the daily volumes or number of securities that are short sold in the market, which can then be disclosed to the public. Some of the advantages of this transactional reporting include providing investors, market authorities and companies with real time information on short sales as well as serving as an audit trail in any potential market abuse. Flagging will also allow the market to judge the extent to which short sales are driving down the price of a particular security.

The FSCA has proposed that this model function as follows:

1. The client must confirm that the transaction is a short sale and provide the authorised user with the name of the issuer of the security, the number of securities being shorted, and the description of the shorted securities either on or before entering into the sale agreement.
2. The authorised user must then flag the short sale on the exchange when the transaction is made. One would hope that this flagging process is integrated into the current exchange system and does not result in any extra burden on the authorised user.
3. Finally, the exchange must publicly disclose on the day the short sales are reported to it, the total number of securities that have been short sold and make this information available on its website. This report should provide an indication of the overall level of short sales that takes place each day across authorised users, as well as the proportion of trades in a particular security that are short sold.

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At a lower threshold of 0.2% of the issued capital of the security, the authorised user must report the short position of the client to the FSCA, who will keep this information private at this point. However, should the short position increase to the higher threshold of 0.5% of the issued capital of the security, then the FSCA will publicly disclose this position.

The second model is the short sale position reporting, which involves a two-tier approach. At a lower threshold of 0.2% of the issued capital of the security, the authorised user must report the short position of the client to the FSCA, who will keep this information private at this point. However, should the short position increase to the higher threshold of 0.5% of the issued capital of the security, then the FSCA will publicly disclose this position. The FSCA has proposed that this model function as follows:

1. The FSCA will create a platform for authorised users to report their short positions, which report must be received by the FSCA before the opening of business three reporting days after the date of the short position.
2. Should the seller maintain a short position that exceeds the thresholds subsequent to reporting, the authorised user must continue to report this until the position is below the threshold. Interestingly, the FSCA does not indicate how regularly such additional reports must be made. Presumably one must continue to report daily, which may become quite burdensome.
3. The FSCA will publish on its website the total of the short positions reported to it on the previous trading day.

For this second model to be useful, and as the FSCA pointed out in its discussion paper, careful consideration must be given to selecting appropriate thresholds. Thresholds that are too high will result in not enough reporting, whilst thresholds too low will result in a flood of reporting, which will render the information fairly meaningless. The FSCA has proposed to utilise percentage thresholds of the issued capital of a particular security only, whilst other jurisdictions have both a percentage threshold and a monetary value threshold as well. Adopting both thresholds will ensure a more robust approach and will serve to capture those securities that are high in quantity (and therefore may not reach the percentage threshold) but are of sufficient value to cause a disruption in the market.

Possible exemptions

The FSCA, in line with IOSCO's principles, has also indicated that it will facilitate exemptions from the reporting frameworks. These exemptions will apply to primary dealers and market makers, but not to all of their activities on the market – only those deemed to be transactions of authorised primary dealers or of a market-making nature. Such exemptions will apply on an instrument by instrument basis and will not be a global exemption for market making activities in all securities. The market maker or authorised primary dealer will be required to make an application for

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Limiting the exemptions to only market-makers and authorised primary dealers may be an issue as it will exclude those engaging in bona fide hedging and arbitrage activities, which generally provide benefits to the market and are unlikely to destabilise it.

exemption to the FSCA. It is unclear at this stage what conditions or requirements the market maker or authorised primary dealer will have to satisfy in order to be granted the exemption. However, limiting the exemptions to only market-makers and authorised primary dealers may be an issue as it will exclude those engaging in bona fide hedging and arbitrage activities, which generally provide benefits to the market and are unlikely to destabilise it.

What next?

The FSCA has given no indication of the repercussions for a failure to report. With the increased regulation, there is the simultaneous need for the development of an adequate and appropriate compliance and enforcement mechanism, especially given that there may be increased costs and burdens on sellers. Whilst this increase in the regulation is a much needed and welcome proposal, many issues remain that require careful consideration. Market participants should act swiftly to voice their concerns.

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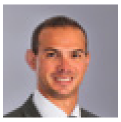

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR
Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 3 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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