STATEMENT SUPPORTING THE DRAFT CONDUCT STANDARD – REQUIREMENTS RELATING TO THE REPORTING AND DISCLOSURE OF SHORT SALES

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FSCA

Financial Sector
Conduct Authority

1 PURPOSE OF THE STATEMENT

1.1 The purpose of this statement is to explain the need for, the expected impact of and the intended operation of the draft Conduct Standard relating to the requirements for reporting and disclosure of short sales, to be made in terms of section 106(1), read with sections 106(2), 106(3) and 108(1) and (2) and of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017) (FSRA).

1.2 This statement is published in terms of section 98 of the FSRA which requires that before a regulator makes a regulatory instrument, it must publish the following documents:
(a) A draft of the regulatory instrument;
(b) a statement explaining the need for and the intended operation of the regulatory instrument;
(c) a statement of the expected impact of the regulatory instrument; and
(d) a notice inviting submissions in relation to the regulatory instrument, stating where, how and by when submissions are to be made.

2 STATEMENT OF NEED - POLICY CONTEXT AND PROBLEM DEFINITION

2.1 Background

2.1.1 Currently, the regulatory framework in South Africa does not prescribe requirements for the reporting and disclosure of short sales on the trading platforms of licenced exchanges.

2.1.2 The FSCA intends to close the regulatory gap created by the lack of a regulatory framework by developing a legal framework prescribing reporting and disclosure requirements consistent with international best practices. The covered short sale reporting and disclosure framework would also ensure alignment of the South African regulatory framework with international standards.

2.1.3 On 20 November 2018, the FSCA published a “Discussion paper on the implementation of a short sale reporting and disclosure framework” (Discussion Paper) for public comment. The comment period was later extended until 15 January 2019.[1]

2.1.4 The Discussion Paper was issued to solicit industry views on the FSCA’s proposal to develop a short sale reporting and disclosure regulatory framework for South Africa. Numerous proposals from the industry were taken into account in the development of the draft Conduct Standard.

2.2 International Standard Setting Bodies and International Best Practice

2.2.1 During the 2008 global financial crisis, several countries implemented emergency measures in relation to short sales because of concerns that this activity was aggravating the downward spiral in share prices thereby posing a threat to individual financial institutions and wider financial stability. Various measures such as restricting short sales to temporarily banning short sales in certain sectors were taken. Other measures included introducing a requirement to flag every short sale on the exchange trading system and the reporting and disclosure of net short positions at certain thresholds.

[1] The comment period was later extended until 15 February 2019.

2.2.2 Due to the financial crisis, IOSCO's Technical Committee set up a Task Force on Short Sales (Task Force). The purpose of the Task Force was to work on eliminating gaps in various regulatory approaches to naked short sales, including requirements and disclosure of short positions. In fulfilling its mandate, the Task Force developed high-level principles for the effective regulation of short sales which were documented in the June 2009 IOSCO Report on the regulation of short sales. Such principles were designed to assist regulators in their development of a regulatory regime for short sales in their jurisdictions.

2.2.3 The Task Force recommended that effective regulation of short sales comprises four requirements as outlined in Principle 37 of the IOSCO's principles of securities regulation. The requirements are as follows:

(a) Short sales should be subject to appropriate controls to reduce or minimise the potential risks that could affect the orderly and efficient functioning and stability of financial markets;

(b) Short sales should be subject to a reporting regime that provides timely information to the market or to market authorities;

(c) Short sales should be subject to an effective compliance and enforcement system. and

(d) Short sales regulation should allow appropriate exceptions/exemptions for certain types of transactions for efficient market functioning and development.

2.2.4 The Financial Sector Assessment Programme (FSAP) review, conducted by the International Monetary Fund (IMF) in 2014 and 2019, concluded that South Africa does not have a reporting and disclosure framework in place for short sales, thus failing to meet principle 37[2] of the objectives and principles of securities regulation issued by the International Organisation of Securities Commissions (IOSCO) in 2010.

2.3 Risks associated with short sales

2.3.1 The inherent risks associated with short sales cannot be ignored. Some of the identified risks associated with short sales are that short sales may be used in an abusive manner to drive down the price of securities to a distorted level, may contribute to disorderly markets (especially in extreme market conditions), and can otherwise have an adverse impact on financial stability in the following manner:

(a) *Market abuse*: The first regulatory concern relates to the way in which short sales may be used to contribute to market abuse. However, its ability to add incremental weight to a downtrend, or to support insider trading by those with adverse information about an issuer, clearly makes it a potentially useful tool for those who are intent on abusing a market. Short sales can be used abusively to create misleading signals about the real supply, or the correct valuation of a security. Behaviours designed to position prices, distort markets or mislead investors normally constitute market abuse;

(b) *Disorderly markets*: As mentioned above, short sales can convey a signal to the market that a firm is overvalued. If investors act appropriately on this signal, this

[2] Committee on Payments and Market Infrastructures (CPMI) and Board of the International Organization of Securities Commissions, *Recovery of financial market infrastructures*, October 2014 (Revised July 2017). Available: https://www.bis.org/cpmi/publ/d162.pdf

may improve the accuracy of the valuation of the security in question. However, if investors over-react the price decline may be excessive. Such volatility reduces the ability of a firm to raise equity capital or to borrow money and makes it very difficult for banks to attract deposits; and

(c) *Settlement risk*: Short sales may also raise regulatory concerns in the area of settlement. Naked short sales give rise to the risk that the seller is unable to deliver securities to the buyer, i.e. there is the risk of settlement failure. This may impair the proper functioning of the market resulting in enhanced transaction costs and sub-optimal levels of trading.

2.4 Need for a regulatory framework in South Africa

2.4.1 The lack of a regulatory framework governing short sale practices exacerbates the risks referred to above.

2.4.2 In addition, in terms of the Financial Markets Act, 2012 (Act. No. 19 of 2012) ("FMA"), the FSCA must have regard to international supervisory standards when executing its regulatory mandate.

2.4.3 Introducing a regulatory framework that will ensure the transparency of covered short sale will have distinct benefits for the market and its users. Greater disclosure will help deter market abuse and reduce the risk of disorderly markets posed by short sales.

2.4.4 A regulatory framework will also provide early warning signs of a build-up of large short positions, thereby alerting the FSCA and Prudential Authority to potential market abuse or emerging systemic risk that will enable the two regulators to effectively monitor the market and take appropriate action where necessary. Public access to information on short sales will also provide informational benefits to the market, improving insight into market dynamics, aiding transparency, and making available important information to assist price discovery.[3]

2.4.5 Short sales are beneficial to the market in that they also contribute to market efficiency. Short sales play an important role in financial markets and are undertaken by a variety of market participants. They also contribute to efficient price discovery, increase market liquidity, and facilitate hedging and other risk management activities.

2.4.6 To reduce the identified risks, the proposed short sale transactional reporting and public disclosure regulatory framework will consist of a short sale transactional reporting and public disclosure framework as well as short sale positional reporting and public disclosure framework.

2.4.7 The proposals put forward in the draft Conduct Standard build on the Discussion Paper that was published for public comment. The submissions that were made on the Discussion Paper were taken into account when formulating the Conduct Standard. For further context, the issues raised during the public consultation process on the Discussion Paper and the FSCA's revised proposals are discussed in paragraph 3 below.

[3] Price discovery is a method of determining the price for a specific commodity or security through basic supply and demand factors related to the market.

3 REVISED PROPOSALS FOLLOWING THE DISCUSSION PAPER CONSULTATION PROCESS

This paragraph must be read together with the proposals put forward in the Discussion Paper.

FLAGGING, REPORTING AND PUBLIC DISCLOSURE OF SHORT SALE TRANSACTIONAL DATA

3.1 Flagging and reporting of short sale transactional data

3.1.1 The Discussion Paper proposed the introduction of a transactional reporting framework based on flagging of short sale orders on an exchange trading system ("transaction reporting"). The transaction reporting proposal essentially entailed that a client will inform an authorised user that a transaction relates to a short sale, and the authorised user must then put a marker or flag on each individual short sale[4] or short sale order, that an authorised user submits on an exchange for execution.

3.1.2 It was further proposed that the transaction reporting data will inform public disclosure of aggregated short sale transactional data, and in this regard the Discussion Paper proposed the implementation of a transactional disclosure framework with public disclosure taking place on the following day (T+1). It was proposed that daily volumes or number of securities that are short sold in the market (otherwise known as gross short sales), should be disclosed to the public by the exchange. Such a report will provide an indication of the proportion of trades in a particular listed security that are sold short, and the overall level of short sales that takes place on the market each day, aggregated across all authorised users.

3.1.3 In general, commentators did not support the proposal that all short sale transactions should be flagged by authorised users, with certain commentators proposing that this obligation be imposed on the client instead. Commentators did support public disclosure of short sale transactions by the exchange; while differing on the exact timelines, it was generally recognized that reporting should be as close to real time as reasonably possible.

3.1.4 Although the majority of commentators did not agree with the flagging of short sale transactions by the authorised users, the FSCA remains in support of a transactional reporting framework. The FSCA is of the view that such framework should be introduced that informs the public of transactional short sale data. Short sell order data provides transactional information, which provides insight into the directional interest of the market on a trading day. The reporting of short sale transactional data to the exchange will lead to public discourse of such data and will also inform the public disclosure of positional data.[5]

3.1.5 If publicly disclosed, such information can help investors and issuers understand share price movements, e.g. if price movements were driven by increased levels of short selling activity in a particular security. Daily reporting of such information will therefore provide timely information to investors and legal entities regarding the level of short selling activity

[4] The determination of a short sale should be calculated using the date and time of the final execution.
[5] As proposed in subsequent paragraphs.

in the market. This will provide support in driving transparency and removing uncertainty in the market surrounding short selling.

3.1.6 One of the other primary benefits of transactional reporting is regulatory in nature. In particular, it will provide information to the FSCA (including an audit trail where transactions are flagged) that will assist it in investigating possible instances of market manipulation involving short selling.

3.1.7 The flagging of short sales by an authorised user on an exchange trading system provides market authorities, investors and companies with real time information of short sales, including intra-day activity, which may particularly be useful in a fast-moving market.

3.1.8 The FSCA therefore maintains the view that there are various advantages in implementing a transactional reporting and public disclosure framework for short sales transactional data (which includes flagging) through the exchanges, including that it allows for greater enforceability of the reporting requirements. This is because the data will be reported through authorised users that are regulated by the exchanges in terms of the exchange's rules and the authorised users have a direct contractual relationship with the exchange.

3.1.9 The FSCA took note of the submissions claiming that authorised users do not always receive complete data that would enable them to flag short sale transactions. However, the proposal is that authorised users will be required to obtain the relevant information from clients before executing transactions on its client's behalf. As mentioned above, the proposed transactional reporting framework is based on the authorised user receiving information from its clients and reporting the information to the exchange, which exchange will in turn collate and release the information to the public. In the view of the FSCA, this should be a cost-effective method of reporting because it will utilise existing infrastructure and communication channels. If disclosure provides a deterrent to significant aggressive short selling, then the benefits in reducing the risk of disorderly markets and the potential for market abuse would flow from the constraints on the scale and timing of short sales. It is acknowledged that the proposal that the authorised user must require its client to notify it if a transaction relates to a short sale might be less effective than merely placing the requirement to notify the authorised user on the client directly.[6] However, the reality is that the legislative framework is restrictive in this regard and does not enable the imposition of legal obligations on clients of authorised users.

3.1.10 It is further noted that, internationally, diverging approaches are adopted insofar as it relates to *on whom* the obligation to disclose short sales data should be placed. The 2009 IOSCO Report on the regulation of short sales merely states that brokers (i.e. authorised users) should be responsible for flagging short sales, and that they should be held accountable for any failure to report short sales. Specific jurisdictional examples include the following:

- In the United States, when an investor places an order with a broker the investor is required to mark the order as "long," "short," or "short exempt.".[7]

[6] If the requirement is placed on the client directly it creates an incentive to comply as non-compliance could attract sanctions. If a legal requirement does not exist, arguably a client will be more reluctant to provide the information. However, the proposals will be framed in such a way that the authorized user must contractually require the client to disclose such information. Non-disclosure by the client will then at least constitute a breach of contract.
[7] See Rule 200 "Marking Requirements" of the SEC's SHO rules.

- In Australia the obligation is placed on the broker and a broker is prohibited from making a short sale on a licensed market on behalf of a seller unless, before making the sale, the broker has asked the seller whether the requested sale is a short sale and has recorded it in writing.
- In Europe, in terms of the European Union Short Selling Regulations (EU SSR), a natural or legal person (investor or broker - trading for its own account) who has a net short position in relation to shares admitted to trading on a trading venue is responsible for reporting and disclosing their net short position to the regulator and to the public.
- In the United Kingdom (UK), following its exit from the European Union, the UK converted the EU SSR into their domestic laws. The UK laws require holders of net short positions in shares admitted to trading on a trading venue in the UK (unless they are exempt) or UK sovereign debt to make notifications to the Financial Conduct Authority once certain thresholds have been breached.
- In Canada the obligation is placed on the investor to confirm whether an order constitutes a short sale. However, the Canadian Regulatory Authority is in the process of proposing amendments to the current regulations to obligate market participants to report and disclose short sales on a daily basis.
- In Hong Kong the broker is required to flag a short sale if the broker knows or was informed that the order relates to a short sale.

3.1.11 The approach adopted in this regard is therefore largely dependent on the regulatory landscape of the respective jurisdictions and the local circumstances. As mentioned, the South African regulatory landscape does not currently enable the FSCA to impose legal obligations on the investor in this way, and for this reason the FSCA proposes an approach similar to Australia and, to an extent, Hong Kong. We may consider submitting proposals to National Treasury to change the law to impose these requirements on the investor directly in due course, to ensure a complete picture for regulators.

3.1.12 It is further acknowledged that the situation regarding the receipt of information from clients and flagging short sale positions is more complicated where it relates to direct market access (DMA) as facilitated by an exchange, for example the JSE, which allows buy–side institutions such as investment managers, hedge funds and proprietary traders access to the JSE's trading system via software provided by a JSE member firm (authorised user). However, it should be noted that Directive B: Transactions and trading procedures of the JSEs Equities Directives ("Directive B"), dated 26 January 2018, already imposes obligations on members that operate an Order Entry Application (OEA)[8] that provides DMA to clients. Directive B, amongst other things, imposes governance requirements on the trading service provider (TSP) and requires JSE approval for a member to operate an OEA.

3.1.13 Paragraph 11 of Directive B provides that the JSE may from time to time request such information from a TSP as the JSE deems necessary to monitor the usage by members and their clients of OEAs that provide DMA and to assess the effectiveness of the

[8] "Order entry application" means any system, software or program operated by a member which facilitates electronic submission of orders to a member trading application and which complies with such requirements as the JSE may from time to time prescribe in the directives.

measures implemented by the member to control the use of such applications on an ongoing basis.

3.1.14 Paragraph 12 provides that a TSP that operates or intends to operate a member trading application or any other system that generates proprietary orders to be submitted to the JSE equities trading system without the intervention of a registered securities trader, may be required to submit such information to the JSE as is deemed necessary to satisfy the JSE that the TSP meets or will meet the objectives of BT 8 and any other requirements in the rules and directives relating to the submission of orders to the JSE equities trading system, in utilising such a system.

3.1.15 The FSCA is of the view that the obligations placed on authorised users through Directive B can potentially be extended to cover flagging of short sale transactions in OEAs that provide DMA. Whilst the authorised user can implement system requirements for clients to flag this trade activity for the market, they would not be responsible for ensuring the accuracy of this information. Therefore, the FSCA maintains the view that the transaction reporting proposal is viable in a DMA environment.

3.2 Public disclosure of transactional data

3.2.1 Consistent with international standards and best practice, the dominant view by commentators was that the data should be disclosed, but there were differing perspectives on whether the exchange or the FSCA itself should do so and in respect of the frequency of such disclosure as mentioned below.

3.2.2 After consideration of inputs, the FSCA considers that the exchange should be responsible for public disclosure of transactional data. Although in most jurisdictions the public disclosure of short positions is carried out by regulatory authorities, in the South African context this is considered a less efficient and effective option. The exchange is best placed to collate and publicly disclose the information to the market as the short sale is flagged on the exchange platform and the exchange already has access to the information that needs to be disseminated. Furthermore, the exchange has the required skilled personnel and computer systems to assists with the collation and packaging of the information. The FSCA will consider whether it is necessary to require exchanges to also report more detailed short sale transaction data, which is not subject to public disclosed, to the FSCA. This has, however, been flagged for a future consideration and will not form part of the current proposals.

3.2.3 The two most important aspects that required careful consideration when formulating the final proposal for public disclosure of short sales transactional data included the following:

i. the frequency of public disclosure of transactional data (i.e. how often public disclosure should take place); and
ii. the content of the information that must be disclosed

3.2.4 Because commentators had divergent views regarding the frequency of public disclosure of transactional data, it was not possible to identity a preference or dominant view from commentators on this proposal. Notably, IOSCO does not provide or recommend the frequency of reporting or disclosure, and different jurisdictions have prescribed different

frequencies for reporting, taking into consideration relevant factors in their local environment.[9]

3.2.5 Consequently, the FSCA retains the view that the public disclosure of transactional short sale data should occur on T+1 because a –

i. shorter time period might not provide sufficient time for the exchange to aggregate and compile the relevant information;
ii. longer time period might result in outdated / untimely information;
iii. it would be too onerous on the exchange to expect real time public disclosure; and
iv. it is international practice to publicly disclose any short sale information on a delayed basis.

3.2.6 With regards to the content of the public disclosure to be made by the exchange in relation to short sales transactional data, the FSCA acknowledges that public availability of short sellers' identities or the authorised users of such short sellers would not provide much, if any, benefit. Thus, anonymous disclosure of aggregated short sale transaction data is supported. The information will provide sufficient insight into the directional interest of the market on a trading day and achieve the intended outcomes of the proposed transactional reporting framework.

3.2.7 It is therefore proposed that aggregated data per security will not be publicly disclosed on authorised user level. An exchange will only be required to publish aggregated short sale transactional data per security of all authorised users combined (volumes of transactions and transactions as a proportion of issued shares). If the FSCA in due course identifies a supervisory need to have transactional information on an authorised user level, the FSCA will consider introducing an obligation on the exchange to report such information to the FSCA.

REPORTING AND PUBLIC DISCLOSURE OF NET SHORT SALE POSITIONAL DATA

3.3 General

3.3.1 Short position data provides positional information, showing the extent of outstanding short interests in a particular listed security. Unlike short order data which captures short interests at the point of order submission, short position data excludes covered positions, e.g. where a person has purchased the security after making the short sell order. Short position data therefore provides information on sustained market sentiments and especially early warning signs of a build-up of large short positions that can alert the FSCA of potential abusive behaviour. It also provides insight to the level of risk involved in shorting a particular security. For instance, a substantially large short position may increase the chances of a short squeeze[10] or increase the difficulty of borrowing the security, for example in a securities lending and borrowing transaction.

[9] To be effective, reporting of short positions should be timely. IOSCO is of the view that the reporting be done as soon as practicable and encourages the market authorities to be mindful of the time lag between the creation of positions and their reporting, it should be as short as possible. IOSCO recognizes, however, that the frequency and timing of reporting to markets and/or market authorities should be determined by each jurisdiction based on its objectives for having short position reporting.

[10] The short seller is exposed to the risk that the shorted shares' prices will increase. If the price rises while the short position is open, then the short seller will be required to either close out the position at a loss or to pledge more cash

3.3.2 Positional reporting provides the most accurate information to the market about the amount of bearish sentiment in a listed security at any time. Changes in the overall short position may provide a signal to other investors that the security is either under or overvalued. Consistent with the objectives of the disclosure framework, this will assist in promoting pricing efficiency in the market and enhance market transparency and efficiency.

3.3.3 Commentators suggested that authorised users should not be obliged to report net short positions because they do not have sufficient information. These comments were noted, however, if the transactional reporting requirements are imposed as proposed above, it would mean that each authorised user will receive data from its clients reflecting a short sale transaction in respect of a particular security. The authorised user will then have to obtain the relevant information from its clients and/or implement software or programs to monitor any changes/ sales its client makes in respect of net open short positions. The authorised user will then be able to collate the net aggregate open short positions across all its clients.

3.3.4 Commentators also proposed that the most effective way of achieving the intended benefits is to place the reporting obligation for both transactional and positional reporting on the client. As discussed above, it is acknowledged that the proposal to indirectly place a reporting obligation on clients through the authorised user contains shortcomings. However, taking into consideration the constraints of the current legislative framework, the FSCA believes that this approach will still result in sufficiently accurate data being received and reported on, which will still provide critical insights into certain key indicators to both the general public as well as the FSCA.

3.3.5 In line with the report of the Technical Committee of IOSCO on transparency of short selling published in June 2003, IOSCO recommends that the reporting and disclosure framework of regulatory Authorities provide for:

- ready access to information on short selling to improve insight into market dynamics;
- deter market abuse;
- mitigate the potential disorderly market effects of aggressive short selling;
- provide early warning signs of a build up of large short positions and alerts to prompt investigation into suspicious activities that may be potentially abusive or disruptive to the orderly functioning or stability of the markets; and
- provide evidentiary proof that aids in post-event investigation and disciplinary action.

3.3.6 IOSCO further recognises in the report that, different markets have different reporting requirements, and that broadly speaking, there are two models that are commonly in use for short selling reporting –flagging of short sales and short positions reporting, and further recognises that some markets require the flagging of short sales while some jurisdictions impose reporting of short positions. Both models have their own merits, and each could serve the above identified regulatory objectives. If national market authorities would like to have a comprehensive reporting regime, they may choose to adopt both models.

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to keep the position open. Stock prices may rise for any number of reasons and if this occurs quickly and is sustained for a period of time then short sellers are caught in what is called a ‘short squeeze’, with the covering of short positions driving up prices further.

3.3.7 Similarly, in relation to the proposal made regarding public disclosure of transactional data, it is the FSCA's view that positional data should rather be reported to the exchange instead of the FSCA, and that the exchange will be responsible for publicly disclosing the data. While the international norm seems to be towards the regulator playing this role, engagement with stakeholders revealed that the authorised users have access and system capabilities already in place to communicate to the exchange. If the authorised user has to report to the FSCA, that will mean system changes and functionality to report to the FSCA which could lead to more costs. It therefore makes practical sense for the exchange to disclose the relevant information to the market.

3.4 Unique identifier (LEI) for purposes of reporting short positions

3.4.1 Due to, amongst other things, global interconnectedness, South Africa should attempt to align to international best practice and, where relevant, other jurisdictions. In terms of the European Union's Markets in Financial Instruments and Amending Regulation (MiFiR), the calculation of short sales should be done at the legal entity (authorised user) level in order to determine volumes of short sales, and therefore short sales should also be disclosed in transaction reports at the legal entity (authorised user) level. The Australian Securities and Investments Commission, for example, also requires a unique number when short sales are reported.

3.4.2 To align to international best practice, the FSCA retains the view that an authorised user, ensure that its client uses an unique identifier when reporting short sale transactions and short positions to the exchange[11]. Such unique identifier will take the form of a LEI issued by a Local Operating Unit to the client.

3.5 To whom should positional short sale data be reported and who should publicly disclose such information?

3.5.1 Following the submissions made, the proposal that the reporting of positional short sale data should be submitted to the FSCA, and the FSCA will then publicly disclose this information if the net aggregate short positions is above the determined threshold, has been reconsidered. The FSCA noted the Report of the Technical Committee of IOSCO on transparency of short selling published in June 2003,[12] which stated that most public disclosure of short selling information is arranged by the exchange and/or other Self-Regulatory Organisations ("SROs") and publication normally takes place via the exchange or SRO websites, as well as in major financial periodicals. Data vendors and others often purchase the data for further distribution, and some develop value-added analysis for their clients (e.g. comparing the short position with outstanding capital, share price performance and daily trading activity).

[11] It is proposed that the exchange will publish the information and the authorised user, nor the exchange will be required to report to the FSCA. Initially it was proposed in the consultation paper that the reporting of positional short sale data should be submitted to the FSCA, and the FSCA will then publicly disclose this information if the net aggregate short positions is above the determined threshold. We have however reconsidered this proposal in line with information published by IOSCO to require the authorised user to report to the exchange and the exchange to publicly disclose.

[12] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD147.pdf

3.5.2 The FSCA agrees that synergies exist for an exchange to aggregate and disseminate positional (as well as transactional) information. Exchanges have access to other market information that may be required to supplement the positional information. For example, the exchange will have access to securities lending information that can be used to verify the accuracy of aggregated positional information. Therefore, the authorised user and the relevant exchanges are potentially in the best position to collect and aggregate positional information. As such, and similar to what is explained in respect of the public disclosure of transactional data, it is proposed that positional data should rather be reported to the exchange instead of the FSCA, and that the exchange will be responsible for publicly disclosing the data

3.6 Content of reporting and public disclosure of positional data

3.6.1 Information asymmetries between informed short sellers and uninformed market participants could result in price inefficiency. In the absence of mandatory disclosure requirements, this information would normally not be made available to the public because it is private information held by a short seller and it is not normally in his or her interests to disclose (as to do so would incur costs and might subject him/her to the risk of a 'bear squeeze').

3.6.2 The FSCA is of the opinion that, similar to the proposal above relating to public disclosure of transactional short sales data, the public disclosure of short sale positional data should also take place on an anonymous basis.

3..6.3 In order to achieve the intended outcomes of public disclosure of positional short sale data (which includes giving an indication of sustained market sentiments and signs of a build-up of large positions) it is proposed that authorised users should report to the exchange –

i. the number of open short positions per security on the exchange, per client expressed as a percentage of issued shares in the security; and
ii. the number of open short positions per security across all clients, also expressed as a percentage of issued shares in the security.

3.6.4 It is proposed that an exchange will aggregate all short sale positional data (as received from the authorised users), per security and per client, and report such onwards to the FSCA for market surveillance, in the interests of monitoring market abuse and large exposures of specific types of securities.

3.6.5 It is further proposed that an exchange be required to publicly disclose the following information one day after receipt of such information (i.e. on T+4):

i. per security, the total number of open short positions in such security aggregated across all authorised users;
ii. per security, the total number of open short positions in such security aggregated across all authorised users expressed as a percentage of issued shares.

3.7 Frequency of reporting and public disclosure of positional data

3.7.1 The central issues in respect of reporting and public disclosure of positional data relate to the content and timeliness of the disclosure. Major considerations in both cases are likely to be the trade-offs between supplying useful information and affording adequate protection to short sellers, and the costs of assembling data taking into account such factors as comprehensiveness, editing and publication frequency.

3.7.2 The FSCA takes note of the significant diversity in views expressed in respect of the proposal relating to the frequency of reporting and public disclosure of positional data. In the FSCA's view, requiring that the reporting and public disclosure of aggregated positional information occurs on a delayed basis results in an appropriate balance between the market's need for timely information against the potential detriment to short sellers of reporting the information. This balance is, potentially, best achieved by requiring authorised users to report their clients' short positions to the exchange three business days after the execution of the trade (i.e. on a T+3 basis). It follows that this information would then be publicly released by the exchange the following day (T+4).

3.7.3 An obvious disadvantage of the T+3 approach is that it results in less timely information being provided to the market than daily reporting. However, the primary advantage of this approach is that it strikes an appropriate balance between providing timely information to the market and addressing industry's concerns that positional reporting might compromise the confidentiality of a short seller's proprietary trading strategies.

3.7.4 The primary disadvantage of weekly and monthly reporting is that short positions would go unreported if they are closed out within a week. This would deny the market the ability to see these positions. This would mean that the information in respect of the short sales would be of less value by the time it reaches the market because it may relate to positions established at the start of the week which would be irrelevant at the time of disclosure.

3.8 Thresholds for reporting and public disclosure of positional short sales data

3.8.1 The FSCA acknowledges that more than half of the commentators were in support of implementing thresholds for reporting and disclosure. This is consistent with the FSCA view. However, identifying the level of the thresholds to generate meaningful information is crucial.

3.8.2 If the thresholds are set too high, then disclosures may be rarely triggered so that the FSCA and/or the exchange may not receive sufficient advance warning of possible market abuse or impending disorderly markets and the market may not receive enough information to help it make informed investment decisions.

3.8.3 If the thresholds are set too low, then the 'warnings' sounded to the FSCA and/or the exchange may be of little value and the compliance costs for market participants may be high and not justifiable. In addition, large numbers of disclosures of positions that are not considered by the market to be meaningful are of questionable value. In particular, the initial public disclosure threshold needs to be set at a level which provides the market with meaningful information about the size of positions without publicising the identities of short sellers, whilst minimising the degree to which trading strategies that do not create disorderly markets are deterred.

3.8.4 It is acknowledged that in determining the reporting threshold due consideration should be given to the liquidity and market capitalisation of the security in that particular market.

3.8.5 In recognising the costs associated with the reporting and public disclosure framework, the FSCA recommends that a *de-minimis* threshold be introduced for authorised users when reporting aggregated positional information to an exchange. This threshold will apply on a client level, i.e. if a client's open position as a percentage of issued shares is below

the determined threshold, then the authorised user does not have to include that information as part of its positional reporting to the exchange. This approach is likely to exclude the reporting of positional information for small retail clients. It is, however, acknowledged that there should be extensive market engagement in the process of setting these threshold levels and these discussions will still take place. Therefore, at this stage the FSCA is not providing detail on the exact level of the threshold that it will be proposing for the reporting of positional information.[13]

3.8.6 With regards to a threshold for public disclosure of aggregated positional data by an exchange, the FSCA is of the view that such a threshold should still be set in order to ease the reporting burden on the authorised user as well as alleviate the collation of information by the exchange. Similar to the threshold for the reporting of positional data to an exchange, the threshold that will apply in respect of the public disclosure of aggregated positional data will also first be subject to market engagement and further consideration by the FSCA.

4 SUMMARY OF THE DRAFT CONDUCT STANDARD

4.1 The objective of the draft Conduct Standard is to enhance confidence, efficiency and integrity[14] in the South African financial markets by providing greater transparency to both investors and the FSCA in respect of short selling activities and to support a fair and efficient market and financial stability.

4.2 The draft Conduct Standard is intended to set out the minimum requirements relating to the reporting and disclosure of short sale. It will thus deal with short sale transactional reporting and public disclosure as well as short sale positional reporting and public disclosure.

4.3 Although the term “short sale” is defined widely in the draft Conduct Standard (e.g. it will include both naked and covered short sales), the restriction contained in paragraph 3 of the draft Conduct Standard (also see below) essentially prohibits short sales where no lending agreement exists. Therefore, naked short sales are not allowed, and the reporting and disclosure obligations only apply in respect of covered short sales. In this regard it might be noted that naked short sales are already prohibited in terms of the JSE Rules.[15]

4.4 The following provides a summary of the proposed requirements prescribed in the draft Conduct Standard to give effect to the stated objectives:

(a) *Restrictions*
The scope of the reporting and disclosure framework is limited to listed securities. In terms of the restriction proposed, only covered short sales are permitted in South

[13] It is important to note that the Authority as a starting point will set thresholds, however taking into consideration the associated risks with thresholds such as the possibility of compromising reports and the quality of the reports disclosed to the public, the Authority will continuously monitor the effect of the thresholds and may reduce or even eliminate these thresholds over time.
[14] Market integrity is understood by the FSCA to mean a fair, efficient and transparent market, in line with IOSCO’s recommendations in respect of principles for securities regulation which focuses on ensuring that markets are fair, efficient, and transparent. This is one of the corner stones upon which all securities Regulators strive to meet their Regulatory objectives.
[15] See JSE Rule 10.50.1 and 10.50.2 and JSE Market Notice100A/2020.

Africa, which essentially means that only a short sale subject to a securities lending arrangement is allowed (i.e. a naked short sale is prohibited).

(b) General obligations

At the outset, an authorised user who facilitates short selling must comply with the generally accepted principles of acting in good faith, and conducting its business transparently, with integrity, honestly, fairly, and with due skill, care and diligence.

(c) Short Sale Transaction Reporting

The draft Conduct Standard introduces requirements in respect of a transactional reporting framework based on flagging of short sale orders on an exchange trading system ("transaction reporting"). The transaction reporting proposal essentially entailed that a client will inform an authorised user that a transaction relates to a short sale, and the authorised user must then put a marker or flag on each individual short sale or short sale order, that an authorised user submits on an exchange for execution.

(d) Short Sale Position Reporting

Positional reporting involves reporting of the net short position of a client of the authorised user (as a proportion of issued capital) in relation to a particular security. It differs from transactional reporting because it excludes reporting of short positions that have been closed out.

(e) Public disclosure of short sale

An exchange will be required to aggregate all short sale transactional data (as flagged on the trading system) for each trading day and publicly disclose the volume of short sales that were traded on the exchange in respect of that security on a particular day, aggregated across all authorised users; and per security, the volume of short sales that were traded on the exchange in respect of that security on a particular day, aggregated across all authorised users, expressed as a percentage of issued shares.

(f) Public disclosure of significant net short positions

In order to achieve the intended outcomes of public disclosure of positional short sale data (which includes giving an indication of sustained market sentiments and signs of a build-up of large positions) it is proposed that authorised users should report to the exchange the number of open short positions per security on the exchange, per client expressed as a percentage of issued shares in the security and the number of open short positions per security across all clients, also expressed as a percentage of issued shares in the security.

It is further proposed that an exchange be required to publicly disclose certain information one day after receipt of such information (i.e. on T+4). Such information includes, per security, the total number of open short positions in such security aggregated across all authorised users and, per security, the total number of open short positions in such security aggregated across all authorised users expressed as a percentage of issued shares.

5 STATEMENT OF IMPACT OF THE CONDUCT STANDARD

5.1 It is envisaged that reporting and disclosure surrounding short selling activities will-

(a) indicate the level of short selling in a particular security;
(b) explain certain share price movements;
(c) provide an early signal that individual securities may be overvalued;
(d) indicate the proportion of sales in an individual security that will need to be reversed by new purchases (to cover the short seller's settlement obligations);
(e) enhance investors' willingness to participate in the market by removing uncertainty surrounding the level of short selling; and
(f) deter market abuse or reduce the opportunities for market abuse, by enabling the FSCA to better identify instances of market manipulation.

5.2 Enhanced transparency of short sales has informational benefits for the market which would outweigh the associated costs. It would help deter and constrain particularly aggressive large-scale short sales which may threaten the maintenance of orderly markets or pose the risk of market abuse and provide early warning signs of a build-up of large, short sales, thereby alerting regulators to potentially abusive behaviour and enabling them to monitor and take action more effectively.

5.3 Facilitating access to information on short sales would provide informational benefits to the market, improving insight into market dynamics and making available important information to assist price discovery.

5.4 Positional reporting provides the most accurate information to the market about the amount of bearish sentiment in a listed security at any time. Changes in the overall short position may provide a signal to other investors that the security is either under or overvalued. Consistent with the objectives of the disclosure framework, this will assist in promoting pricing efficiency in the market and enhance market transparency and efficiency.

5.5 The draft Conduct Standard is therefore envisaged to reduce risk in the short selling environment and contribute to market transparency.

5.6 Further the Conduct Standard will ensure alignment with international best practice such as IOSCO and compliance with the FSAP recommendations, which will serve as signal to both local and foreign investors that South Africa is a jurisdiction that complies with international standards and international recommendations, making it a trusted market.

5.7 In terms of the regulatory costs associated with transactional and positional reporting, it is acknowledged that some changes to existing systems are required, especially for authorised users to enable the receipt of short sale information from clients, particularly in the case of DMA as discussed above, and to facilitate the flagging of this information to the exchange.

5.8 The FSCA, however, believes that there are synergies in collecting this information from the authorised user. If the benefits of the disclosure obligations are compared with the costs of changes to the systems, the benefits outweigh the costs. Notwithstanding the above, the FSCA welcomes any further submissions on expected cost implications associated with the introduction of the proposed transactional and positional reporting framework.

5.9 Further, it is likely that the majority of these costs will entail once-off costs for authorised users and exchanges to develop their internal systems.

5.10 In addition, in recognising the costs associated with the reporting and public disclosure framework, the FSCA recommends that a *de-minimis* threshold be introduced for authorised users when reporting aggregated positional information to an exchange. This threshold will apply on a client level, i.e., if a client's open position as a percentage of issued shares is below the determined threshold, then the authorised user does not have to include that information as part of its positional reporting to the exchange. It is expected that the levels at which the reporting and disclosure thresholds are set will assist in reducing some of the cost implications as it will result in less reporting.

5.11 The proposed framework should also result in a cost-effective method of reporting and disclosure because it enables the utilisation of existing infrastructure and communication channels. If disclosure provides a deterrent to significant aggressive short selling, then the benefits in reducing the risk of disorderly markets and the potential for market abuse would flow from the constraints on the scale and timing of short sales.

6 STATEMENT OF INTENDED OPERATION OF THE CONDUCT STANDARD

6.1 The proposed requirements prescribed in the draft Conduct Standard are consistent with the objective of the FSRA, the respective objectives of the FSCA, and specifically the mandate of the FSCA to maintain a transparent, efficient and stable financial system that functions in the interests of financial customers and supports balanced and sustainable economic growth.

6.2 The proposed requirements in the draft Conduct Standard will apply to all listed securities and will be limited to covered short sale only.

6.3 The Conduct Standard will be made after the process prescribed in the FSRA has been concluded. Authorised Users and exchanges will be required to comply with the Conduct Standard with immediate effect once it is published.

6.4 Following the implementation of the Conduct Standard, the FSCA will assess and evaluate the effectiveness of the Conduct Standard on a continuous basis as part of its regulatory and supervisory responsibility to ensure that any unintended consequences of the Conduct Standard affecting the industry are adequately addressed.