The Global Dilemma in Short Selling Regulation: IOSCO's Information Disclosure Proposals and the Potential for Regulatory Arbitrage

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INTRODUCTION

The tumultuous events leading up to the financial crisis in the fall of 2008 resulted in the rapid enactment of global securities rules and regulations that were designed to limit, curb, or outright ban short selling activity. Undoubtedly, Credit Default Swaps played a critical role in corroding the global economy by providing insurance on risky mortgage bonds and encouraging reckless behavior during the housing bubble. However, according to many regulatory authorities, short sellers greatly exacerbated global economic turmoil, driving some of the world’s largest financial institutions to the brink of ruin. Indeed, some industry experts debate that the bankruptcy of Lehman Brothers Holdings Inc., (“Lehman Brothers”)—the largest in history—could have been avoided had Wall Street been restrained from “practicing one of its darkest arts.” The same experts have expressed concerns that certain short selling techniques may amount to “gasoline on the fire” in distressed markets.

In order to respond to unprecedented deterioration of market stability and investor confidence in the financial sector, national regulatory authorities imposed bans or additional restrictions on short selling with great haste and little or no notice. The resulting regulatory measures exposed a general lack of consistency among national regulators concerning the types of restrictions imposed on short selling as well as short po-

1. A Credit Default Swap (“CDS”) is a contract, where the buyer pays a premium and the seller agrees to make a specific payment if a particular event, such as a bond default, occurs. Thus, if an investor is holding certain bonds and is concerned that the issuer will not be able to pay, purchasing CDSs should cover the potential loss. In this manner, CDS transfers credit risk among market participants. See Nicholas Varchaver & Katie Benner, The $55 Trillion Question, FORTUNE, Oct. 13, 2008, at 134.
2. See id.
5. Id. (quoting U.S. Senator Ted Kaufman).
sition disclosure requirements. In order to resolve this global regulatory disparity, the Task Force of the Technical Committee of the International Organization of Securities Commission (“IOSCO” or the “organization”) issued its Final Report on Regulation of Short Selling (“Short Selling Report”). The report identified the primary risks attributed to short selling and proposed four regulatory principles designed to limit those risks, while retaining certain market benefits associated with short selling activity. However, while IOSCO’s Short Selling Report aimed at providing a consistent global approach to short selling regulation in

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7. See id.
8. IOSCO’s Technical Committee is a “specialized working group, made up of fifteen agencies that regulate some of the world’s larger, more developed and internationalized markets.” Press Release, Int’l Org. of Sec. Comm’ns, IOSCO Launches Task Force On Recent Market Events (Nov. 8, 2007), available at http://www.iasplus.com/iosco/0711subprime.pdf. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. Id. Kathleen Casey, Commissioner, Securities and Exchange Commission, is the Chairman of the Technical Committee. Members of the Technical Committee, INT’L ORG. OF SEC. COMM’NS, http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (last visited Oct. 16, 2009). Other members of the Technical Committee are regulatory agencies located in the Netherlands, Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, Ontario, Quebec, Spain, Switzerland, United Kingdom, and the United States. Id. The Technical Committee’s Task Force is generally comprised of the same agencies as the Technical Committee but is chaired by the Securities and Futures Committee, Hong Kong. See INT’L ORG. OF SEC. COMM’NS, CONSULTATION REPORT REGULATION OF SHORT SELLING (2009), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf [hereinafter SHORT SELLING REPORT]; IOSCO Committee Lists, INT’L ORG. OF SEC. COMM’NS, http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (last visited Oct. 16, 2009).
9. IOSCO is the International Organization of Securities Commissions comprised of member agencies that have resolved, through its permanent structures, “to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.” See About IOSCO, INT’L ORG. OF SEC. COMM’NS, http://www.iosco.org/about/ (last visited Nov. 4, 2009). The Objectives and Principles of Securities Regulation published by IOSCO in February of 2008 set out the three objectives of securities regulation: (1) the protection of investors, (2) ensuring that markets are fair, efficient and transparent, and (3) the reduction of systemic risk. See INT’L ORG. OF SEC. COMM’NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION at i (2008), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf [hereinafter OBJECTIVES AND PRINCIPLES REPORT].
10. See SHORT SELLING REPORT, supra note 8.
11. Id.
the areas of compliance, enforcement, and disclosure obligations, the Short Selling Report did not offer a specific regulatory mechanism to achieve these goals.

This Note will suggest that IOSCO’s one-size-fits-all approach to short selling regulation ultimately fails to set forth meaningful regulatory standards that are applicable on an international basis. This Note will further intimate that the absence of such standards, especially with regard to consistent information disclosure obligations, may result in information asymmetry among jurisdictions, leaving the gate open for regulatory short selling arbitrage, which hinders market efficiency. Finally, this Note will conclude that IOSCO should address concerns arising from the dissonance in short selling disclosure regulations by implementing meaningful and consistent disclosure and reporting standards. In this vein, IOSCO could follow the Committee of European Securities Regulators’ (“CESR”) approach in determining the most consistent regulatory disclosure requirements, which maximize the utility of short selling information in the market. Such measures would undoubtedly promote the effectiveness of global short selling regulation and minimize the risk of regulatory arbitrage.

II. BACKGROUND

The objective of the Short Selling Report was to develop broad regulatory principles designed to assist domestic regulators in constructing a national short selling regulatory regime. The goal of IOSCO’s proposed principles was to enhance investor protection, market fairness, efficiency, and transparency, and to reduce systemic risk. In this vein, the organization considered the nature of short selling, its risks and benefits, and its role in the global economy. IOSCO’s four principles of short selling regulation discussed in this Note reflect the organization’s view that while short selling plays an important role in the global markets, certain methods of short selling, such as naked short selling, pose serious economic risks and should be restrained.

12. Id. at 4–5.
13. Id.
14. For a discussion of CESR approach, see infra Part III.
15. SHORT SELLING REPORT, supra note 8, at 4 (discussing the background and purpose of IOSCO’s four principles of short selling regulation in the Executive Summary).
16. Id.
17. Id.
18. Id.
A. The Benefits and Risks of Short Selling in the Global Economy

Although the precise legal definition of short selling varies according to jurisdiction, a transaction is generally defined as a short sale when it involves the sale of stock that the seller does not legally own at the time of the sale. Investors normally seek to make a profit from constantly fluctuating prices of securities that are traded on the markets. If investors believe that a company’s stock price will decline (e.g., due to the company’s announcement of lower than anticipated earnings), they will place themselves in a position to profit from this event by selling the company’s stock. However, if such investors do not own the company’s stock at the relevant time, they may borrow the stock from other investors (or “lenders”), sell it in the market, and deliver it to the buyer. If the short seller is correct in thinking that the stock’s price will decline, he or she will purchase the stock at the lower price and return it to the lender, thereby making a profit.

The utility of short selling has historically been a subject of debate between those who espouse the ability of short selling to increase market transparency and critics, who highlight its propensity to destabilize security markets.

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19. IOSCO’s Technical Committee accumulated certain short selling features common to most jurisdictions into a ‘bucketed’ definition. A particular transaction is defined as a falling within the ‘realm of short selling’ if it consists of the following two factors: (1) a sale of stock and (2) that the seller does not own at the point of sale. Short Selling Report, supra note 8 at 24; see also Piero Cinquegrana, Short Selling: A Known Unknown (European Capital Mkts. Inst., ECMI Commentary No. 23/29, 2009), available at http://www.ceps.eu/node/1671.


21. Id.

22. Shares are often borrowed from a long-term share owner, such as an insurance fund or a pension fund, and the owner will receive lending fees from the borrower. See Financial Services Authority, Short Selling, Discussion Paper, 2009, 09/1, at 6, available at http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf [hereinafter FSA Short Selling Paper].

23. Id.

24. In other words, the classic theory for short selling rests upon the premise that an investor believes that negative information concerning an issuer (such as lower earnings, major litigation, or a downturn in the sector) will lead to a decline in the price of its publicly-traded securities. Based on this belief, the investor will sell the stock at the current price, deliver the borrowed shares to the buyer, and repurchase those shares later in the market when the share price will purportedly be lower based on the investor’s theory. Norton, supra note 20, at 5; Sheehan, supra note 6.

25. Transparency may be defined as the degree to which information about trading is made publicly-available on a real-time basis. Objectives and Principles Report, supra note 9, at 6.
security prices during stressful market periods.\textsuperscript{26} Proponent economists consider short selling to be instrumental in "unearthing overvalued companies and contributing to efficient stock prices."\textsuperscript{27} For instance, some market analysts believe that without the ability to short sell, stock prices would rise and become overvalued, shutting relevant negative information out of the market.\textsuperscript{28} In this manner, short selling contributes to the price discovery of a particular security.\textsuperscript{29} Certain empirical evidence also highlights that short sellers tend to be the better informed market participants and when short sellers are shut out of the market, stocks tend to be more expensive and generate abnormally low future returns.\textsuperscript{30} In sum, the benefits incurred by the market from nonabusive short selling activity include correcting overpriced stock, facilitating hedging and risk management techniques\textsuperscript{31} and providing liquidity\textsuperscript{32} to the markets.\textsuperscript{33}

Conversely, critics of short selling consider it to be a largely speculative and high risk activity.\textsuperscript{34} A short seller has the potential to incur essentially unlimited losses if the price of the security continuously rises

\textsuperscript{26} Id.
\textsuperscript{28} Boehmer, Jones & Zhang, supra note 27, at 2.
\textsuperscript{29} Price discovery could be described as a method of determining the price of a specific security through basic supply and demand factors related to the market. Investopedia, \textit{Price Discovery}, http://www.investopedia.com/terms/p/pricediscovery.asp (last visited Jan. 28, 2010).
\textsuperscript{30} Boehmer, Jones & Zhang, supra note 27, at 3.
\textsuperscript{31} For example, curtailing the risk of a long position in stock or call options via establishing a short position in the stock. See \textit{id}.
\textsuperscript{32} Liquidity may be defined as “being readily convertible to cash.” With respect to securities, a stock is considered liquid when there are enough shares trading in the market so that large transactions can occur without substantial price variations. \textit{Black’s Law Dictionary} (8th ed. 2004); see also Lauricella, \textit{supra} note 3.
\textsuperscript{33} See Boehner, Jones & Zhang, \textit{supra} note 27.
\textsuperscript{34} The Committee of European Securities Regulators (“CESR”), \textit{Measures Adopted by CESR Members on Short Selling}, CESR/08–742 (2009) (emphasizing that unregulated short selling may increase market risk) [hereinafter CESR \textit{Short Selling Measures}]. CESR is an independent Committee of European Securities Regulators. See CESR in \textit{Short}, http://www.cesr.eu.org/index.php?page=cesrshort&emac=0&id= (last visited Dec. 10, 2009). CESR’s mission is to improve coordination among securities regulators, act as an advisory group to assist the EU Commission and work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States. \textit{Id}.
rather than falls. Furthermore, market authorities stipulate that unregulated short selling may lead to more serious and damaging consequences such as creation of disorderly markets, settlement disruptions, and market abuse. In fact, many commentators have blamed short sellers for past stock market declines and crashes—from the financial troubles of the East India Company in 1609, to the stock market crash of 1929, to the 2008 global financial crisis. Thus, most market authorities attempt to regulate short selling with an objective of retaining the benefits, while mitigating the risks.

In the Short Selling Report, IOSCO classified the risks inherent in unregulated short selling activity into three categories of regulatory and market risk, which are common to most jurisdictions. The first category concerns the accelerant-like effect of short selling on an issuer that creates a spiraling downward pressure on the share prices of stock. Essentially, the speed and weight of aggressive short selling may cause market disorder when investors do not have enough time to respond to the increasing downward pressure on the stock. This activity may cause potential buyers to withhold from purchasing the security and encourage holders of the security to sell it. If the price of the stock decreases exponentially, the issuer will have difficulty borrowing money and attracting investors, such that it cannot improve its financial condition before its stock becomes worthless.

37. INT’L SEC. LENDING ASS’N, SECURITIES LENDING AND SHORT SELLING (2009), available at http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SECURITIES%20LENDING%20AND%20SHORT%20SELLING%20(3).pdf ("The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. ISLA has more than 100 members comprising insurance companies, pension funds, asset managers, banks and securities dealers representing more than 4,000 clients. Whilst based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America.") [hereinafter SECURITIES LENDING AND SHORT SELLING].
38. See, e.g., Boehmer, Jones & Zhang, supra note 27.
39. See generally Amendments to Regulation SHO, supra note 36; FSA SHORT SELLING, supra note 22; SHORT SELLING REPORT, supra note 8.
40. SHORT SELLING REPORT, supra note 8, at 7, 22.
41. FSA SHORT SELLING PAPER, supra note 22, at 12.
42. Id. at 11–14.
gressive short selling of the bank’s shares may also lead to depositor run. In this sense, normal fluctuations of stock prices are exacerbated by aggressive short selling, which has the potential to lead the issuer into bankruptcy even though it may be otherwise well-capitalized. Therefore, the activity of aggressive short selling may itself be disorderly, in addition to the fact that the outcome of such activity may lead to undesirable consequences.

The second regulatory concern identified by IOSCO is the potential for abusive market behavior. Abusive market behavior is apparent when short selling, accompanied by false rumors designed to encourage others to sell, drives down the price of the security and triggers a large profit at the expense of the issuer whose security is being oversold. The regulatory concern highlighted in this instance is that short selling may provide a valuable tool for those who intend to abuse the market. Regulators often define market abuse or market manipulation as an illegal “intentional interference with the free forces of supply and demand.” Although the definition of manipulative activity varies slightly among jurisdictions, most regulatory authorities recognize that when a market participant spreads false rumors designed to encourage others to sell, and he or she sells the security in question, such activity is a “clear case of abusive behavior.”

43. A depositor run or “bank run” takes place when the customers of a bank fear that the bank will become insolvent. Customers rush to the bank to take out their money as quickly as possible to avoid losing it. In this situation, short selling may become a rapid self-fulfilling prophecy resulting in the potential collapse of issuers that are targeted by the short sellers. About.com: Economics, Bank Run—Dictionary Definition of Bank Run, http://economics.about.com/cs/economicsglossary/g/bank_run.htm (last visited Oct. 1, 2010); see also FSA SHORT SELLING PAPER, supra note 22, at 12.

44. TRANSPARENCY REPORT, supra note 35, at 22.

45. See SHORT SELLING REPORT, supra note 8.

46. Id at 22.

47. Id.

48. SECURITIES LENDING AND SHORT SELLING, supra note 37, at 4 (explaining that propensity to abuse the market may arise from any other form of trading, so the regulatory concern in this instance is not that short selling is an abusive strategy in itself).

49. John D. Finnerty, Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation 2–4 (Mar. 2005) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687282 (explaining that manipulative trading strategies—such as releasing false information about a company into the market, naked short selling and employing trading strategies that impede the price formation process—corrupt the market’s price formation process, and inject misleading information into the market to move stock prices in the direction that benefits the manipulator. It is important to note that market manipulation can be profitable when there is a difference between the price elasticity of purchases and sales that the manipulator can exploit).

50. SHORT SELLING REPORT, supra note 8, at 22.
For example, some market authorities blamed abusive short selling for exacerbating the circumstances which eventually led to the collapse of Bear Stearns & Co., Inc. (“Bear Stearns”) and Lehman Brothers.\textsuperscript{51} According to the Financial Services Authority (“FSA”), market conditions in the fall of 2008 led to an unacceptably high risk of abusive behavior, precipitated by false rumors and aggressive short selling, which created self-fulfilling prophesies with respect to the collapse of already vulnerable issuers (such as Bear Stearns and Lehman Brothers).\textsuperscript{52} In a similar manner, some market analysts contend that American International Group, Inc. (“AIG”) may have averted the need for government financial assistance had its stock price not been driven down by short sellers, thereby triggering a credit downgrade, which then required the company to raise $14 billion in capital overnight in order to meet collateral requirements on its credit default swaps.\textsuperscript{53}

The third regulatory concern identified by IOSCO regarding short selling is the potential for settlement disruption, which causes difficulties for the purchasers of the security.\textsuperscript{54} Settlement disruption\textsuperscript{55} may arise in the context of “naked” short selling, where the short seller has not borrowed or arranged to borrow the securities ahead of the sale.\textsuperscript{56} As a result, the seller fails to deliver securities to the buyer when delivery is due.\textsuperscript{57} Naked short selling may increase the potential for market abuse by


\textsuperscript{52} FSA SHORT SELLING PAPER, supra note 22.

\textsuperscript{53} Saporito, supra note 51.

\textsuperscript{54} “Settlement” is the date on which payment is made for a trade. For stocks traded on US exchanges, settlement is currently three business days after the trade. In some regional markets, foreign shares may require months to settle. \textit{Id}; see also Bloomberg Financial Glossary, http://www.bloomberg.com/invest/glossary/bfgloss.htm (last visited Oct. 19, 2009).

\textsuperscript{55} See Saporito, supra note 51.

\textsuperscript{56} Settlement disruption is a situation where one party pays for the shares he or she purchased and the counterparty (i.e., the short seller) does not deliver the shares (and vice-versa). \textit{See} SECURITIES LENDING AND SHORT SELLING, supra note 37. Short selling carries with it a certain level of “settlement risk.” \textit{Id}. Settlement risk, sometimes called “Herstatt risk,” was “named after the well-known failure of the German bank Herstatt whose license was withdrawn by regulators on June 26 1974 due to its inability to cover its liabilities. This forced the bank into liquidation and it ceased operating.” Reuters Financial Glossary, http://glossary.reuters.com/index.php?title=Herstatt_Risk&redirect=no (last visited Oct. 16, 2009). When German banking regulators closed the bank down, counter parties were left with substantial losses. \textit{Id}.

\textsuperscript{57} Amendments to Regulation SHO, supra note 36, at 5.

\textsuperscript{58} This is also known as “failure to deliver” or “fail.” \textit{See} SEC, Naked Short Sales, http://www.sec.gov/answers/nakedshortsale.htm (last visited Dec. 12, 2009).
manipulating the price of a particular security. Price manipulation occurs when the naked short seller creates an overall imbalance in the supply and demand in the securities markets, thereby influencing the price of the targeted issuer’s stock. Without the stock borrowing requirement, a short sale effectively increases the supply of a targeted issuer’s stock, which, in turn, decreases the stock’s price. The theory is that the artificial increase in a company’s outstanding stock essentially devalues it, and the failure to deliver the shares is tantamount to issuing new stock without the company’s permission. The Securities and Exchange Commission (“SEC”) has recognized that short sellers may intentionally fail to deliver securities as part of a scheme to manipulate (i.e., artificially decrease) their price. The injection into the market of misleading information concerning the supply and the price of an issuer’s stock causes unwarranted reputational damage to the issuer and undermines investor confidence in the issuer’s financial stability. In addition, untimely delivery may hinder the purchaser’s ability to meet obligations with respect to an onward series of transactions.

Naked short selling also gives rise to potential corporate governance issues. For example, when naked short selling leads to settlement failure, shareholders are deprived of their stock ownership benefits, such as...
voting. This is because the buyer of so-called “phantom shares” created by the naked short seller believes that they are real shares and therefore hold voting rights. Consequently, “if brokers send the proxy materials to owners of phantom shares who then vote for them, there could be more votes cast for the directors than actually exist.”

The impact of settlement disruption is illustrated in the collapse of Lehman Brothers. Because of the lack of controls applicable to short selling, “as many as 32.8 million shares in Lehman Brothers were sold and not delivered to buyers on time as of Sept. 11[, 2008], according to data compiled by the Securities and Exchange Commission and Bloomberg.”

Many industry professionals believed that the naked short selling of Lehman Brothers stock, coupled with the alleged spread of false rumors designed to encourage others to sell the stock, may have been largely responsible for the firm’s demise. In a similar case, stock delivery failures increased for Bear Stearns as well, peaking the day after it was announced that JPMorgan Chase & Co. would acquire the company for two dollars per share. Although both Lehman Brothers and Bear Stearns were experiencing grave financial problems during 2008, the theory was that short sellers were exacerbating the situation by driving their stock prices lower than they should have been with such speed that recovery was virtually impossible.

Without regulatory constraints, naked short selling may threaten the stability of broader markets and create “systemic risk.” Systemic risk has been broadly defined as the potential breakdown in an entire system, where “an event will trigger a loss of economic value or confidence . . . in a substantial portion of the financial system that is serious enough to . . . have significant adverse effects on the real economy.” In this scenario, the magnitude and/or speed of short selling are not constrained by the short seller’s ability to borrow the stock in the market before executing the sale. This trading technique generally increases the manipulator’s  

68. SECURITIES LENDING AND SHORT SELLING, supra note 37, at 4.
69. Matsumoto, supra note 4.
70. Id. at 1 (quoting Richard Fuld, former Chief Executive Officer of Lehman Brothers).
71. Id.
72. See, e.g., Posting of Alex Singleton to Telegraph, Short Selling Helped Promote Truth About HBOS and Lehman Brothers, http://blogs.telegraph.co.uk (Sept. 18, 2008).
73. See FSA SHORT SELLING PAPER, supra note 22.
74. ORG. FOR ECON. CO-OPERATION AND DEV., G10 REPORT ON CONSOLIDATION IN THE FINANCIAL SECTOR (2001), available at http://www.oecd.org/document/60/0,3343,end_2649_34593_1895868_1_1_1_1,00.html [hereinafter G10 REPORT].
75. FSA SHORT SELLING PAPER, supra note 22, at 11; see also id.
profit and aggravates price decline of the underlying stock.\textsuperscript{76} In this sense, naked short selling can be especially damaging to an issuer’s stock price because “ignoring the regulatory requirement to borrow the shares eliminates the main quantitative constraint on the amount of short selling and intensifies the resulting downward pressure on price.”\textsuperscript{77} Significant price declines in the stock of issuers that has been subject to extensive naked short selling can create a crisis in investor confidence without a fundamental underlying reason. In the financial world, contagious loss of investor confidence in the market creates a high probability of systemic breakdown.\textsuperscript{78} Once a financial event has become systemic, economic effects may include bank runs, failures of illiquid but solvent firms, and reductions in the supply of funds to finance profitable investment opportunities.\textsuperscript{79}

\textbf{B. Regulatory Restraints on Short Selling}

Due to the risks posed by unregulated short selling, regulatory authorities in countries with the most active global capital markets have maintained some forms of restrictive measures controlling naked short selling activities.\textsuperscript{80} The events leading up to the bankruptcies of Bear Stearns and Lehman Brothers led regulators worldwide to conclude that short selling was used in an abusive manner, creating widespread investor panic and destabilizing the markets.\textsuperscript{81} As part of its response to the ensuing market instability, the SEC, for example, issued a temporary order restricting short selling in the shares of 19 financial firms deemed systemi-

\textsuperscript{76} Finnerty, \textit{supra} 49, at 5–6, 33.

\textsuperscript{77} At the extreme, short position in a stock may even exceed a firm’s entire supply of outstanding shares. \textit{Id.} at 33.

\textsuperscript{78} See G10 \textit{REPORT}, \textit{supra} note 74.

\textsuperscript{79} See \textit{id.} (explaining that most systemic crises that have occurred in G10 and other countries in the past 50 years have exhibited at least one of the defining characteristics of systemic risk).

\textsuperscript{80} Cinquegrana, \textit{supra} note 19, at 10–14 (explaining that although “different jurisdictions use the term ‘naked’ in slightly different ways, the common regulatory concern . . . is that a seller does not own the stock he is selling and has made no provision to borrow or provide for delivery of stock to the purchaser by the settlement date”); see, \textit{e.g.}, Amendments to Regulation SHO, \textit{supra} note 36 (where the SEC has made permanent a temporary rule that was approved in 2008 in response to continuing concerns regarding “fails to deliver” and potentially abusive “naked” short selling. In particular, temporary Rule 204T makes it a violation of Regulation SHO and imposes penalties if a market participant does not purchase or borrow shares to close—out a “fail to deliver” resulting from a short sale in any equity security. . . . Moreover, Regulation SHO reflects the SEC’s concern that “pervious restrictions on short selling had not been effective in preventing its use as manipulative device).

\textsuperscript{81} See Matsumoto, \textit{supra} note 4; see also FSA \textit{SHORT SELLING PAPER}, \textit{supra} note 22.
cally important, by reinforcing the penalties for failing to deliver the shares on time.\(^{82}\) In September 2008, the Securities and Exchange Commission temporarily banned short selling in 799 stocks, while the FSA instituted its own short selling ban on 29 leading financial stocks.\(^{83}\) When the financial crisis of 2008 reached international markets, global regulatory agencies took emergency actions to further restrain, or outright prohibit short selling activities. The regulatory efforts included outright jurisdiction-wide bans on short selling, partial bans on certain types of short selling activities, and the institution of short position disclosure and reporting requirements in view of the permitted short selling activities.\(^{84}\)

However, the regulatory measures implemented by global market authorities in order to restrain potentially abusive short selling were largely dissimilar across jurisdictions.\(^{85}\) Regulatory judgments of what constituted abusive short selling varied according to jurisdiction. In addition, domestic regulatory efforts were largely uncoordinated with respect to the types of restrictions imposed on short selling and short position disclosure requirements.\(^{86}\) For example, after the SEC banned short selling for 799 stocks in September 2008, Taiwan, Netherlands, and France enacted outright country-wide bans of all short selling activities.\(^{87}\) Full bans on short selling were eventually lifted in all jurisdictions with developed capital markets. Consequently, many national regulators enhanced certain disclosure-based controls over short selling.\(^{88}\)


\(^{83}\) Cinquegrana, supra note 19, at 5.

\(^{84}\) Sheehan, supra note 6, at 1–2.

\(^{85}\) TRANSPARENCY REPORT, supra note 35.

\(^{86}\) Id.

\(^{87}\) Australia suspended covered short selling on all stocks. Cinquegrana supra note 19, at 5. Canadian regulatory authority also banned the short selling of all financial stocks. Id.

\(^{88}\) IOSCO’s Technical Committee recognized the concern stemming from unregulated short-selling activities:

The Technical Committee believes that short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities. However, there is also a general concern that especially in extreme market conditions, certain types of short selling, or the use of short selling in combination with certain abusive strategies, may contribute to disorderly markets.

SHORT SELLING REPORT, supra note 8, at 4 (quoting the Executive Summary of the Report); see also TRANSPARENCY REPORT, supra note 35.
The implementation of short position disclosure requirements reflects the theory that short position disclosure generally provides valuable information to the market and informed markets are less prone to manipulation and disorder. Valuable information related to short selling activity, if widely available, could enhance market transparency, which is one of the theoretical conditions required for the free markets to function efficiently. Essentially, well-informed markets exhibit less information asymmetry and present less opportunity for arbitrageurs to profit at the expense of uninformed market participants. Sufficient disclosure can also remove the opportunity for market manipulators to spread false rumors designed to influence trading activity, and can thereby deter market manipulation. However, when regulatory disclosure requirements differ among jurisdictions, the timeliness and availability of information in those jurisdictions are affected. As a consequence, regulatory efforts aimed at curbing market manipulation may be undermined if manipulators take advantage of information asymmetry among different jurisdictions.

C. The Risks Information Asymmetry and the Potential for Regulatory Arbitrage

Conventional financial theory suggests that market efficiency stems from informational efficiency. For example, a market may be more efficient when security prices reflect more information useful to investors within shorter periods of time. Information asymmetry can occur when one market participant has more or better information than another market participant. This creates an imbalance of power in transactions, giving rise to potentially large discrepancies between buy and sell orders when better-informed participants exploit their informational advantage.

89. See Transparency Report, supra note 35.
90. Id.
91. A market is said to be transparent if information is available with regard to the relevant assets and prices trading on the market. Id.
92. Id.
93. For example, in some jurisdictions disclosure involves publishing cumulative short sales volumes in individual securities on a daily basis, while in others it involves periodic publication of the overall short position in individual securities as measured at a specific moment. See id. at 14, 21.
96. See id.
Some studies suggest that over a long time horizon, there is a negative association between disclosure quality and information asymmetry.97 Analogously, higher quality of information disclosure may contribute to the balancing of power among the buyers and sellers in the market, or decrease the average level of asymmetry among investors. This phenomenon can be applied to regulatory short position disclosure requirements.98 Any market efficiencies created by short selling have the potential of being offset by the information asymmetry with regard to other market participants who are unaware of the short sales.99 This may be especially true in developed capital markets, where the prices of publicly-traded securities reflect a “mechanism for communicating information.”100 Thus, failing to disclose the amount of short interest in a stock may remove certain negative information about the issuer from the market, rendering the market less efficient. It is important to note, however, that disclosure quality and effectiveness ultimately depends on the amount, timeliness, and precision of the disclosed information.101

Even though disclosure-based short selling regulations exist in many jurisdictions, these regulations vary with respect to the scope of the disclosures and short position reporting requirements. Divergent disclosure regulations also give rise to regulatory compliance issues for companies that operate internationally.102 These companies are operationally and financially burdened by having to comply with a multiplicity of different regimes.103 Arguably, the greater concern is a threat to market efficiency, where different short position disclosure requirements among jurisdictions may lead to information asymmetry and open the gate for regulatory arbitrage.

Regulatory conflicts may develop when some jurisdictions take the view that the market is benefitted by rigorous short position disclosures, while other jurisdictions deem such disclosure requirements to be inefficient or prefer different disclosure approaches. The ensuing divergence in regulatory regimes may give rise to regulatory arbitrage, which indicates a migration trend toward the more lenient regulatory regimes, and is often associated with a “race to the bottom” argument.104 The race to

97. See id. (referencing studies of information asymmetry and disclosures).
98. Empirical studies suggest that this will occur over a long time period. Id.
99. SHORT SELLING REPORT, supra note 8, at 14.
100. Licht, supra note 94, at 609 (citing F. Hayek, The Use of Knowledge in Society, 35 AM. ECON. REV. 527 (1945)).
102. FSA SHORT SELLING PAPER, supra note 22, at 23.
103. Id.
104. See Licht, supra note 94.
the bottom argument recognizes that when two jurisdictions with different regulatory regimes are pitted against each other, market participants will find a way to adopt whatever regulatory framework they feel is best.\textsuperscript{105} When competing regulatory regimes simultaneously interact with one another, certain externalities are exerted on those subject to a particular regime.\textsuperscript{106} One such externality is the erosion of regulatory effect on market participants.\textsuperscript{107} This may develop when companies have multiple stock listings and international operations.\textsuperscript{108} For example, if one jurisdiction implements stringent exchange-listing rules for the purpose of curbing certain activity, a company may avoid the more stringent rules by listing its stock in a different jurisdiction with less demanding listing standards.\textsuperscript{109}

Similarly, with respect to information disclosure obligations, when a stock trades on multiple markets with varying regulatory disclosure regimes, arbitrageurs may use trading information obtained from one jurisdiction, which is untimely or unavailable in another jurisdiction, in order to profit at the expense of uninformed market participants. In this regulatory arbitrage scenario, the economic “law of one price” theory is significantly shattered.\textsuperscript{110} This theory holds that “if an identical commodity or asset sells in two different markets, then the price of this item should be the same barring transaction costs.”\textsuperscript{111} “Departure from [this theory] may lead to arbitrage profits, generated from buying the underpriced security or selling the overpriced security.”\textsuperscript{112} In this manner, arbitrageurs may profit when information obtained from one market indicates that the same security is overpriced in another market because the latter does not reflect certain relevant negative information, such as the level of short interest in the security. After acquiring the necessary negative information about the security in the more informed market, the arbitrageur will sell what he believes to be an overpriced security in the less informed market, thereby profiting from the divergence of regulatory disclosure regimes. Therefore, regulatory arbitrage may occur as a consequence of

\begin{thebibliography}{12}
\bibitem{106} Licht, \textit{supra} note 94, at 633.
\bibitem{107} \textit{Id.} at 630–33.
\bibitem{108} \textit{Id.} at 630
\bibitem{109} \textit{Id.}
\bibitem{110} \textit{See id.} at 590.
\bibitem{111} \textit{Id.} (quoting Kiyoshi Kato et al., \textit{Are There Arbitrage Opportunities in the Market for American Depository Receipts?}, 1 \textit{J. Int’l. Fin. Markets, Institutions & Money} 73 (1991)).
\bibitem{112} \textit{Id.}
\end{thebibliography}
different disclosure regimes when some market participants profit financially from the less informed markets. 113

In addition, different short position disclosure requirements may contribute to the free-rider problem. 114 In this scenario, a market that captures valuable information through disclosure requirements will invite free-rider markets, which do not implement rigorous disclosure obligations. 115 Essentially, free-riders wind up utilizing the information obtained from more informed markets without incurring the costs of generating that information. 116 Another externality of different short position disclosure requirements is the fact that markets with less rigorous disclosure regimes resort to “chasing” the information. 117 Consequently, when relevant information is conveyed to the free-rider market at a time lag, arbitrageurs are presented with the opportunity to take advantage of the less informed markets.

D. IOSCO’s Role in Implementing Internationally-Consistent Short Selling Regulatory Principles

As presented above, discerning the consequences of the interactions of different regulatory regimes is essential when international regulatory initiatives are considered by such organizations as IOSCO. 118 The organization’s members cooperate to propose internationally-consistent regulatory guidelines via published reports or consultation papers. 119 IOSCO’s publications set forth proposed legal or regulatory principles, which are not automatically codified into binding international or domestic law. 120 When the proposed guidelines are accepted and implemented by the international community and domestic securities regulators, IOSCO principles often evolve into “soft law,” which represents “non-binding standards and principles of conduct.” 121

As a voluntary international standard-setting body, IOSCO’s soft law is developed largely through its consultation papers and reports (such as

113. Id. at 567.
114. Id.
115. Id. at 566–67.
116. Id at 566.
117. Id.
118. Id. at 567.
120. Karmel & Kelly, supra note 105, at 883–86.
121. Id. at 884, 885 (explaining that while IOSCO’s members pledge to implement the Organization’s standards domestically, the standards do not have the force of either international or domestic law).
the Short Selling Report), which aim to guide regulatory behavior.\textsuperscript{122} On the surface, IOSCO lacks the force of either international or national law, and its enforcement power is largely toothless.\textsuperscript{123} However, IOSCO’s soft law can “harden” when countries incorporate the organization’s principles into statutes and binding domestic law.\textsuperscript{124} In fact, many statutes in the securities field are enacted in response to some current financial concerns, and because international organizations like IOSCO are generally thought to be more efficient and faster at responding to current socioeconomic events,\textsuperscript{125} domestic regulations are often drafted in the shadow of soft law.\textsuperscript{126} Therefore, IOSCO’s presence in the international securities industry has a significant effect on developing effective international regulatory measures, which are likely to be incorporated into binding domestic securities law.

In the current global markets, securities regulations are no longer considered “domestic” due to the magnitude of financial globalization and innovation.\textsuperscript{127} As illustrated by the regulatory arbitrage phenomenon, regulatory principles implemented in one jurisdiction may have significant consequences on the market participants in other jurisdictions.\textsuperscript{128} This is the reason that international cooperation by national regulatory authorities is absolutely vital.\textsuperscript{129} Indeed, many authorities perceive soft law as the better medium through which market conditions are addressed faster and more effectively, both on an international scale and domestically.\textsuperscript{130} For example, in response to the 2007 market turmoil surrounding Credit Rating Agencies (“CRAs”), United States government offi-

\textsuperscript{122} Id. at 894.
\textsuperscript{123} Id. at 885.
\textsuperscript{124} Id. at 884 (for example, the SEC incorporated IOSCO’s best practices into binding legal rules governing the US securities industry).
\textsuperscript{125} “[S]oft law is frequently more informed and more effective than statutory law . . .” Id. at 885.
\textsuperscript{126} Id.
\textsuperscript{129} Id.
\textsuperscript{130} Karmel & Kelly, supra note 105, at 890 (emphasizing that the alternative means, namely treaty and customary law enactments take much longer to develop and conclude, and do not provide the speed and efficiency needed for dynamic markets).
cials swiftly passed legislation granting authority to the SEC to exercise regulatory oversight of CRAs. The SEC turned to IOSCO for assistance in formulating standards of conduct applicable to CRAs. After the SEC implemented appropriate regulations, the Commission then proceeded with enforcement actions.

Although IOSCO’s Code of Conduct concerning the regulation of CRAs was welcomed by some, critics condemned the rules for not going far enough. It became clear to some industry experts that without meaningful and consistent regulatory principles, the process of incorporating soft law into domestic legislation may lead to under-enforcement of the established regulations and a lack of efficient compliance mechanisms. As a consequence, implementation of IOSCO’s soft law may “leave us without real rules that actually implement the policies that are needed.” Indeed, some industry experts believe that many of IOSCO’s recommendations set forth in the Short Selling Report do not provide meaningful and enforceable regulatory guidelines.

II. THE REGULATORY APPROACH TO SHORT SELLING — IOSCO’S FOUR PRINCIPLES

In its Short Selling Report, IOSCO proposes four regulatory principles, which aim to eliminate “gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions.” The goal of IOSCO’s proposed principles is to develop a consistent approach to short selling regulation in the international community. The four principles are comprised of the following recommendations:

- Short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets;
- Short selling should be subject to a reporting regime that provides timely information to the market or market authorities;
- Short selling should be subject to an effective compliance and enforcement system;

131. Id. at 886–96.
132. Id. at 924–29.
133. Id. at 928.
134. Id. at 885–86, 896.
135. See id. at 932.
136. McCreevy Speech, supra note 127.
137. SHORT SELLING REPORT, supra note 8, at 4.
138. Id.
Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.\textsuperscript{139}

IOSCO’s first three principles identify the significance of placing appropriate controls on short selling activity, implementing consistent short position disclosure requirements, and ensuring appropriate compliance and enforcement procedures.\textsuperscript{140} The fourth principle recognizes that the practice of short selling has certain market benefits, if conducted in a regulated, nonabusive manner.\textsuperscript{141} This Note will briefly discuss the first, third and fourth principles of short selling regulation. It will then focus on IOSCO’s second principle, which suggests a short selling reporting regime that aims to provide timely information to the relevant entities. The Note will argue that IOSCO’s recommended approach to short position disclosure and reporting requirements does not set forth consistent regulatory standards applicable on an international level. This Note will further suggest that allowing some markets to be more informed than others creates information asymmetry among jurisdictions and invites regulatory arbitrage. As a possible solution, this Note will offer CESR’s approach to formulating regulatory short position disclosure standards for all jurisdictions within the European Union. Finally, this Note will suggest that while CESR’s specific disclosure standards may not be optimal for all jurisdictions, its formulaic approach offers an effective method of implementing consistent regulatory standards that minimize potential information asymmetry and regulatory arbitrage issues related to divergent regulatory regimes.

\textit{A. An Overview of IOSCO’s First, Third, and Forth Principles of Short Selling Regulation}

In its first principle of short selling regulation, IOSCO recommends a minimum requirement of enforcing strict settlement of failed trades.\textsuperscript{142} This can be achieved by compulsory buy-in (or close-out)\textsuperscript{143} require-

\textsuperscript{139} \textit{SHORT SELLING REPORT, supra} note 8, at 6.

\textsuperscript{140} \textit{Id.}

\textsuperscript{141} See \textit{id.}

\textsuperscript{142} \textit{Id. at} 8.

\textsuperscript{143} Compulsory buy-in or close-out may be requested by the buyer who has not received the stocks after a certain number of days. Alternatively, the process may be initiated by the central counterparty of the securities settlement system. In addition, some markets impose monetary penalty on those who have failed to settle their trades within the standard settlement cycle. See \textit{SHORT SELLING REPORT supra} note 8, at 10.
ments. IOSCO also proposes a shorter trade settlement cycle,\footnote{Settlement cycle is the “time lapse between trade execution to the settlement of trade.”\textit{Id}.} where trades are settled no later than T+3 (i.e., three days after execution), to avoid the risk of settlement disruption.\footnote{See \textit{id}.} IOSCO’s recommendations in this area directly address one of its main concerns with respect to settlement risk (one of the risks closely associated with naked short selling).\footnote{Strict settlement rules have the potential to discourage and deter abusive short selling behavior (i.e., “those who short sold with no intention of . . . delivery”). See \textit{SHORT SELLING REPORT, supra} note 8.} Moreover, IOSCO’s approach to regulating settlement disruption presents clear regulatory guidelines, which could be applied consistently, on an international level.

IOSCO’s third principle of short selling regulation addresses the implementation of international compliance and enforcement systems.\footnote{\textit{Id.} at 17–20.} The basic tools for effective cross-border enforcement cooperation are set out in IOSCO Objectives and Principles of Securities Regulation, and IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU).\footnote{\textit{Id.}} This Note does not examine compliance and enforcement procedures as such assessment would draw upon extensive literature analyzing legal and regulatory systems, as well as the availability of resources dedicated to such endeavor. IOSCO’s fourth principle deals with exceptions for certain types of transactions and seems consistent, mutatis mutandis, with the approach taken by most regulatory authorities with developed capital markets.\footnote{See \textit{SHORT SELLING REPORT, supra} note 8.}\footnote{\textit{Id.} at 11–15 (emphasis added).}

\subsection*{B. The Need for Consistent Short Selling Information Disclosure Requirements— IOSCO’s Second Principle of Short Selling Regulation}

In contrast with IOSCO’s clear standards for settlement discipline formulated under the first principle of short selling regulation, the organization fails to set forth similar guidelines with respect to short selling information disclosure obligations. Instead, the organization’s second principle of short selling regulation confirms what is already known to the international community: that jurisdictions should “consider some form of reporting of short selling information either to the market or to market authorities.”\footnote{\textit{Id.} at 11–15 (emphasis added).} However, IOSCO’s proposal does not offer the necessary
regulatory clarity and consistency with respect to disclosure requirements to the companies and market participants that operate on an international level.\textsuperscript{151}

Many market authorities have recognized that the globalization of the securities markets has created a need for the sharing of information among regulators and market participants.\textsuperscript{152} In jurisdictions with developed capital markets, some regulators, such as the SEC, aim to regulate the markets by promoting the disclosure of relevant trading information rather than directly intervening in the functioning of a free market economy.\textsuperscript{153} The theory supporting this regulatory approach is that by ensuring that investors possess relevant information, mandatory disclosure “leverages market discipline as a means of accountability that stands in contrast to more substantive government oversight.”\textsuperscript{154} For example, the inclusion of risk factors in issuer’s prospectuses reflects the SEC’s long-held view that all investors should have access to a “common pool of knowledge” in order to judge for themselves whether to buy, to sell, or to hold a particular security.\textsuperscript{155} It follows that the role of the regulators in this type of a regime is to create high quality, disclosure-based regulations that will supply the market with the optimal amount of information necessary for the market participants to make sound investment decisions. As such, IOSCO’s second principle, merits further consideration, namely with respect to the purpose of short position disclosure and reporting obligations.

In the securities markets, the price of a security ideally reflects all publicly-available information about the issuer, as well as other economic

\textsuperscript{151} See \textit{id}.

\textsuperscript{152} Karmel & Kelly, supra note 105, at 914.

\textsuperscript{153} Christopher Cox, Chairman, SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission’s Disclosure System (Oct. 8, 2008), available at http://www.sec.gov/news/speech/2008/spch100808cc.htm (explaining that since its foundation, the SEC’s purpose has been to maintain investor confidence in the markets by providing them with reliable information).

\textsuperscript{154} Troy A. Paredes, Commissioner, SEC, Remarks before the Symposium on “The Past, Present and Future of the SEC” (Oct. 16, 2009), available at http://www.sec.gov/news/speech/2008/spch101609tap.htm (explaining that collective judgment of the informed marketplace should be respected as a worthy alternative to more substantive government control of private sector conduct) [hereinafter Paredes Speech].

\textsuperscript{155} The SEC believes that “[o]nly through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation’s economy.” The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://sec.gov/about/whattwedo.shtml (last visited Jan. 29, 2010).
conditions. For financial markets to function, the information driving the trading of the securities should be reliable and transparent.\textsuperscript{156} Thus, disclosure requirements are necessary to achieve transparency in the market and place market participants in a position to effectively evaluate investment opportunities.\textsuperscript{157}

While public knowledge of short selling differs among jurisdictions, markets where short position disclosure requirements are implemented tend to be better informed than those where there are no such requirements.\textsuperscript{158} This is in part because short position disclosures may enhance the availability of information related to the issuers and the price of their securities. Specifically, short sellers, by betting on a company’s stock price decline, signal to the market their view of the company’s prospects.\textsuperscript{159} In this manner, greater disclosure about short selling activities may provide more information to the market about an issuer, which in turn may enhance price discovery. A better-informed market makes it more difficult for market manipulators to spread false rumors in order to manipulate the price of a security.\textsuperscript{160} In this sense, regulatory disclosures operate as a necessary means to ensure investor protection.\textsuperscript{161} Therefore, appropriate levels of short selling disclosure may supply investors with relevant information, enhance market efficiency and potentially deter market abuse.\textsuperscript{162} It is important to note that reporting of short positions should be timely to prevent information from becoming stale before it reaches the market.\textsuperscript{163}

While disclosure of information is generally considered to be an effective means of achieving market efficiency and investor protection, not all information is valuable, and information may be subject to misinterpretation.\textsuperscript{164} Information overload (i.e., when too much information is released into the market) impairs the ability of a market participant to distinguish what is important in making his or her investment decisions and frustrates the purpose of the disclosure.\textsuperscript{165} Moreover, the information ob-

\textsuperscript{156} Indeed, some regulatory authorities consider that insufficient transparency was at the heart of the 2008 financial crisis. Cox Speech, \textit{supra} note128.
\textsuperscript{157} Paredes Speech, \textit{supra} note 154.
\textsuperscript{158} \textsc{Transparency Report}, \textit{supra} note 35.
\textsuperscript{159} In this manner, short sellers contribute to assessing the true value of a company’s stock. \textit{Id}.
\textsuperscript{160} Sheehan, \textit{supra} note 6, at 9.
\textsuperscript{161} \textit{Id}.
\textsuperscript{162} \textit{Id}.
\textsuperscript{163} \textsc{Short Selling Report}, \textit{supra} note 8, at 14.
\textsuperscript{164} \textit{Id}.
\textsuperscript{165} Paredes Speech, \textit{supra} note 154 (explaining that when information is not processed and interpreted effectively, disclosure does not translate into better decision-
tained from a short sale may be ambiguous and open to various interpretations.166 A short sale itself may not provide enough information to the market about the short seller’s motive. For example, from the short itself it may be unclear whether the short seller sold the security short in order to express a negative view about the issuer or simply hedge167 another position.

Mandatory disclosure also imposes substantial compliance costs on market participants.168 Such costs are normally related to the implementation of disclosure mechanisms and compliance costs incurred by the constituents subject to the regulatory disclosure regime. An additional cost of information disclosure may be incurred by the market where public disclosure of short positions could compromise proprietary trading strategies169 and discourage hedging activity.170 Because industry experts recognize non-manipulative short selling strategies, including hedging, as socially valuable, markets may actually become less transparent and consequently, less informed when stringent disclosure obligations result in overall less short selling.171 Empirical studies further suggest that high quality disclosures reduce the incentives for market participants to search for information.172 In other words, full transparency in the market will give the investors less incentive to gather new information because they

making. As Justice Marshall (quoted by Commissioner Paredes) stated, “management’s fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making.” Therefore disclosure can result in less transparency and worse decisions.

166. SHORT SELLING REPORT, supra note 8, at 15.

167. A hedge is an investment made for the purpose of reducing the risk of adverse price movements in an asset. Investopedia, Hedge Definition, http://www.investopedia.com/terms/h/hedge.asp (last visited Jan. 27, 2010). Investors use this strategy when they are unsure of what the market will do. Id. For example, if an investor believes that the stock price of an issuer will rise in the near term due to a positive event for that issuer, the investor will purchase the issuer’s stock. However, since the investor is interested in the issuer rather than the industry, he or she may hedge industry risk (or the risk that the industry which the issuer is in will experience decline) by short selling an equal value of shares of the issuer’s direct competitor, who happens to be in the same industry. Id. In this manner, the investor decreases, or hedges industry risk related to the stock he or she desires to purchase. Id.

168. SHORT SELLING REPORT, supra note 8, at 4–6.

169. “Proprietary” relates to information in which the owner has a protectable interest. BLACK’S LAW DICTIONARY (8th ed. 2004).

170. TRANSPARENCY REPORT, supra note 35, at 15–17 (describing short sale disclosure as a two—edged sword); id. at 5.


172. Brown and Hillegeist, supra note 95.
would not be compensated for the resources they expend. Therefore, many regulatory authorities recognize the importance of providing the market with valuable information, while attempting to maintain the incentives for market participants to search for new information.

In sum, when establishing disclosure and reporting regimes, regulators should be clear about the objectives of such regulations. The above-mentioned evidence concerning the effects of short position disclosure on the markets indicates that the most optimal regulations would ensure that investors receive socially-valuable information resulting from short selling activity and protect proprietary interests in gathering new information. Therefore, it is important to identify specific disclosure requirements that will allow for the most beneficial flow of information to the public markets. IOSCO’s second principle of short selling regulation identifies various disclosure methods implemented by different jurisdictions but does not advance a solution that would unify current short position disclosure regimes.

C. IOSCO’s Disclosure Approach Poses the Risks of Information Asymmetry and Regulatory Arbitrage

As discussed earlier, the primary motivation for legislative measures with respect to short selling is to ensure more effective reporting of short selling information. In order to achieve this result, domestic regulators have implemented largely divergent approaches to setting short selling disclosure obligations for market participants. IOSCO’s second principle of short selling regulation addresses international discrepancies in reporting requirements by identifying two different methods of disclosure: (1) flagging of short sales and (2) short positions reporting. While IOSCO recognizes that “both models have their own merits,” it neither endorses a specific measure, nor proposes a consistent regulatory standard for short position disclosure requirements. This approach

173. FSA SHORT SELLING REPORT, supra note 22.
175. SHORT SELLING REPORT, supra note 8.
176. Sheehan, supra note 6, at 27.
177. TRANSPARENCY REPORT, supra note 35.
178. CESR SHORT SELLING MEASURES, supra note 34, at 6; SHORT SELLING REPORT, supra note 8, at 16 (explaining that the strategy makes a short sale trade easily traceable).
179. CESR defines this concept as the “requirement to report individual significant short positions whether to the regulator and/or the market.” THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS (“CESR”), MODEL FOR A PAN-EUROPEAN SHORT SELLING DISCLOSURE REGIME, CESR/10-088 (Mar. 2010); Short Selling Report, supra note 8, at 16.
180. SHORT SELLING REPORT, supra note 8, at 12.
sends a mixed message to the international securities industry and does not resolve the issue of regulatory dissonance in the area.

Although the flagging method is used by some countries such as Canada and Greece, IOSCO and CESR have identified certain flaws with mandating uniform flagging requirements.181 This method requires a marker to be placed on each individual short sale order that a broker sends to a regulated market or alternative trading venue for execution.182 The market then reads the order as a short sale, rather than just a sale of a security.183 One issue with this approach is that while flagging short sales provides regulators with real-time data encompassing intra-day activities, the process of its aggregation raises issues of information redundancy (e.g., a large part of this information is already captured in the form of stock lending data).184 The concern is that the costs incurred through aggregating and disclosing already-available information may outweigh any potential benefit of releasing such information into the market.185 In addition, the market may encounter information overload, as supplying it with duplicative information will likely confuse, rather than help market participants.186

The flagging approach also presents a lack of clarity with respect to the actual outstanding short positions, such that regulators would not be able to readily identify large short positions or aggressive short selling.187 Marking an order as a short sale does not necessarily offer specific insight into whether the short seller is expressing a negative view about the issuer or simply hedging his position.188 Therefore, market authorities would not receive enough information via flagging to determine whether a market participant is aggressively short selling the issuer’s stock to manipulate the price of the stock, to express concerns about the issuer’s financial health, or to simply hedge other positions.189 In addition, be-

182. SHORT SELLING REPORT, supra note 8, at 15.
183. Id.
184. CESR SHORT SELLING MEASURES, supra note 34; SHORT SELLING REPORT, supra note 8, at 16.
185. SHORT SELLING REPORT, supra note 8, at 16.
186. See FSA SHORT SELLING REPORT, supra note 22.
187. See id.; SHORT SELLING REPORT, supra note 8.
188. See FSA SHORT SELLING REPORT, supra note 22.
189. Even if purchase orders, which cancel out the existing short position, are flagged, this issue cannot be completely resolved. This is because “short sellers do not need to go to the market to close the short positions in some cases. For example, they may acquire
cause only a few jurisdictions implement this approach, achieving uniformity via flagging would be extremely cumbersome on market participants. Regulated entities and/or stock exchanges that are currently subject to disclosure-based regimes would be required to contribute or divert considerable resources to operational and compliance measures in order to implement the system. In sum, while IOSCO does not take a definitive position on flagging as a disclosure mechanism, the SEC, FSA and CESR all favor short position reporting instead of the flagging approach, as way to disclose short sales to the market.

Short position disclosure necessarily requires a system of reporting short selling information either to the market or market authorities. In developing a system of reporting, regulators must balance the utility of information disclosure to the market against the costs of providing such information. Among other things, short position reporting raises concerns with respect to the appropriate trigger level of reporting, whether the focus should be on net or gross short position reporting, the timing of reporting, the types of securities reportable, and whether the short position details should be confidentially disclosed to the regulators or publicly disclosed to the market. The notification of short positions exceeding a de minimis level deals with the trigger level of short positions reporting. For example, some markets require reporting of existing short positions once the positions exceed 0.25% of the issued share capital of the relevant stocks. The Short Selling Report suggests that the trigger level of reporting should not be set so high as to prevent the flow of useful information. On the other hand, setting the threshold too low may be overly burdensome on those responsible for reporting. Essentially, IOSCO leaves the issue of determining the trigger level at the discretion of national regulators.
The decision regarding whether short position reporting should be implemented on a gross or net basis means determining whether to report current overall short sales of an issuer (gross basis) or current overall exposure to an issuer (net basis). The benefit of net position reporting is that it takes into account long positions in the stock, which may cancel out the short positions. For example, if the holder of a disclosed gross short position also has a similar-sized long position in the issuer, the positions cancel out and the holder is in fact “flat.” Gross position reporting does not take this into account and only shows the holder’s total short exposure to the issuer. Thus, net position reporting may be more useful than gross position reporting because it provides more accurate information about the total current short interest in the security.

In order to be effective, IOSCO suggests that short position reporting should be timely. The time lag between the creation of positions and their reporting may render the information stale. The timeliness of available information raises the issue of whether short position information should be reported confidentially to the market authorities or publicly disclosed to the market. Public disclosure of significant individual short positions may have harmful commercial effects mentioned earlier, such as the disclosure of a proprietary trading strategy. In addition, public disclosure may make those holding large short positions in an issuer subject to a “short squeeze.” In this situation, when the demand for stock exceeds its supply, the rapid increase in the price of the stock may force short sellers to purchase the stock at a substantially higher price in order to cover their short positions, thus incurring large economic losses from the transaction.

201. Id.
202. FSA Short Selling Report, supra note 22.
203. Id.
204. This is especially relevant when a holder of disclosed gross short position also has a similarly—sized long position, which cancels out his short position. As such, gross position disclosure would not reflect accurate information related to the investor’s total holdings of the security. Id. at 30.
205. Short Selling Report, supra note 8, at 14.
206. See FSA Short Selling Report, supra note 22.
207. See discussion, supra p. 26.
208. See FSA Short Selling Report, supra note 22.
While public disclosure of short positions poses commercial concerns, confidential disclosure to a regulator may be less efficient due to the time lag created by reporting the information to market authorities before disclosing it publically.210 As the time lag increases, the potential benefits derived from disclosures in terms of informed decision-making decrease.211 Still, disclosure to regulatory authorities may be helpful in identifying any unusual short selling activities potentially giving rise to market abuse.212 Once notified of potentially troublesome transactions, a regulator would then be able to determine whether intervention is required.213

While addressing each of the above considerations, IOSCO fails to arrive at an internationally consistent approach or set a minimum threshold of short position reporting, instead leaving the ultimate decision with domestic regulators.214 The organization’s second principle of short selling regulation also does not take into consideration every asset class in which a seller may express short interest.215 For example, securities that trade as common stock in the local market are also available to trade in foreign markets as depository receipts.216 When trading in the same security is fragmented among different markets, arbitrageurs stand ready to take advantage of any gap that develops in the price of the security. As discussed earlier, because the price of a security ideally reflects all relevant information pertaining to the issuer, any information asymmetries resulting from different regulatory regimes may in fact create an arbitrage opportunity.217 This is because information asymmetry could potentially affect the pricing of securities that trade on numerous national markets.218 In other words, if the regulatory regime in one jurisdiction

210. FSA SHORT SELLING REPORT, supra note 22, at 29.
211. Id.
212. Id.
213. Id.
214. See id.
215. Id.
216. Depository receipts are “negotiable certificate[s] held in the bank of one country representing a specific number of shares of a stock traded on an exchange of another country. [These may] make it easier for individuals to invest in foreign companies, due to the widespread availability of price information, lower transaction costs, and timely dividend distributions.” Investor Words, Global Depository Receipt Definition, http://www.investorwords.com/2180/Global_Depositary_Receipt.html (last visited Oct 23, 2009).
217. See discussion, supra pp.16–17.
218. For example, the price of the security trading on Hong Kong’s exchange may incorporate certain information that is not available and therefore not incorporated in the price of the same security trading in the US market. In fact, IOSCO recognized this issue
institutes less rigorous (or ineffective) short selling disclosure requirements, the price of a security trading in that jurisdiction will reflect less information about the issuer. Consequently, the same security trading in a different jurisdiction with more rigorous disclosure requirements will have a different price because it will likely reflect more information. The market which is dominant in the provision of information would also be dominant in the pricing of the securities traded on that market. In this manner, information asymmetry stemming from different regulatory regimes may contribute to the difference in the prices of same security trading in different jurisdictions. The subsequent price difference of the same security may create a riskless profit opportunity and further contribute to regulatory arbitrage.

Another potential effect of regulatory arbitrage stemming from different short position disclosure requirements is the frustration of purpose or values advanced by the domestic regulatory regime. To illustrate, if a market participant wishes to short sell a stock that is exchange-listed in a jurisdiction that requires full position disclosure, he or she may be inclined to circumvent more stringent disclosure regulations by short selling the depository receipts, which are trading in a jurisdiction with less aggressive disclosure requirements. This is problematic when two jurisdictions have strong but opposite opinions as to what level of disclosure is best. The jurisdiction which adheres to stringent disclosure principles will find that its regulations are undermined when investors choose to short sell depository receipts, which trade in a jurisdiction with less stringent disclosure requirements. IOSCO’s principles do not address this regulatory concern.

IOSCO’s Short Selling Report repeatedly concedes that the regulation of short selling activities varies from jurisdiction to jurisdiction, depending on a range of domestic factors, including, but not limited to, market conditions and domestic regulatory landscape. Responding to these concerns, “international standards usually grant a fair amount of discretion to national regulators.” However, IOSCO grants national regulators virtually unlimited discretion in implementing short sale reporting

See TRANSPARENCY REPORT, supra note 35, at 23 (stating that an issue might arise if different venues are subject to different disclosure requirements).

219. Licht, supra note 94, at 566.

220. See id.

221. See id.

222. Id. at 630.

223. See id.

224. Karmel & Kelly, supra note 105, at 963.
obligations. The organization’s failure to resolve regulatory dissonance leaves national regulators with no other source for arriving at consistent international standards of short selling regulation in times of greatest economic need. Discretion is by definition nontransparent, and the fact that IOSCO’s national regulators develop standards that grant those same regulators virtually unlimited discretion is troubling, as this ultimately leaves securities regulation in the hands of national regulators who are not required to arrive at consistent international standards. Therefore, while some discretion should be afforded to national regulators in order to fine-tune IOSCO’s principles of securities regulation to be more in line with domestic needs, unlimited discretion could leave the markets without any internationally consistent regulatory principles. The organization’s Short Selling Report fails to address the concern shared by many regulators that information asymmetries between informed short sellers and uninformed market participants could result in price variations. Once price variations occur, the gateway is opened for regulatory arbitrage, where market manipulators are free to take advantage of less-informed markets.

III. CESR’S SHORT POSITION DISCLOSURE APPROACH

There are a number of different approaches to implementing internationally consistent short position disclosure regulations. For example, the SEC, permits confidential short position disclosures to regulatory authorities, while Self-Regulatory Organizations publish daily short selling volume and individual short sale transactions. The FSA, on the other hand, considers public disclosure of relevant short sale positions to be the key in improving transparency and market efficiency. One possible solution that attempts to reconcile conflicting disclosure standards is CESR’s two-tiered system of disclosure.

225. See SHORT SELLING REPORT, supra note 8; see also OBJECTIVES AND PRINCIPLES REPORT, supra note 9, at 3.
227. Id. at 935–946.
228. Id.
229. FSA SHORT SELLING PAPER, supra note 22, at 13.
230. TRANSPARENCY REPORT, supra note 35, at 20–23.
231. Amendments to Regulation SHO, supra note 36.
CESR’s first level of disclosure is the private short position disclosure to a national regulator when that position reaches a specified initial threshold (CESR proposes to set this threshold at 0.1% of the company’s issued share capital). This technique provides the regulators with early warning signs of large short position accumulations, thereby alerting them to potentially abusive behavior and allowing them to monitor and take action more effectively. If the short position reaches a second-tier threshold (proposed at 0.5%), the holder of the position would be required to publicly disclose the position to the market. Disclosure calculations and reports would be made on a net basis and reported on the day following the day on which the relevant trigger threshold was crossed. CESR also makes room for exemptions from disclosure obligations for short positions resulting from market making activities.

IV. CONCLUSION

While CESR’s approach is subject to some criticism, its objectives are not unlike those of IOSCO, in that CESR aims at harmonizing the disclosure regime for short selling within the European Union. As such, CESR illustrates that it is possible to implement clear, meaningful standards with respect to short selling regulation and disclosure requirements. While this Note does not advocate CESR’s specific approach as the best-fitting international regulatory measure for short position disclosure, CESR’s approach illustrates a compromise among the European Union’s national regulators and an implementation of functional and specific regulatory standards.

IOSCO is an “international association of securities regulators with tremendous influence on the development of international norms for the regulation of securities.” In times of economic crises, international legislative bodies tend to look to IOSCO for advice on appropriate reg-

234. Id.
235. Id. at 5.
236. Any private or public disclosure would also be necessary if the positions fell below any of the trigger thresholds or crossed the incremental 0.1%. Id.
237. Any long economic exposures to the subject security would need to be subtracted from the short position. Id.; CESR SHORT SELLING MEASURES, supra note 34.
238. See CESR SHORT SELLING MEASURES, supra note 34.
239. Id. Generally, market makers are entities that as part of their businesses, deal as principals in securities in order to (i) fulfill clients’ orders and/or (ii) provide liquidity on a regular basis to the market on both, bid and offer sides. FSA SHORT SELLING PAPER, supra note 22, at 33.
240. See Deloitte Financial Group, supra note 232.
241. Id.
242. Karmel & Kelly, supra note 105, at 898 (internal quotations omitted).
latory measures and to “bring a consensus to the complex and divergent regimes that exist globally.”\textsuperscript{243} To wit, it is the only organization with the power to develop internationally consistent standards of short selling regulation through its consultation papers and reports.\textsuperscript{244}

Without clear and consistent guidelines, regulatory dissonance in disclosure obligations breeds information asymmetry among jurisdictions, which erodes market efficiency. The differences in regulatory short position disclosure regimes may also invite unwanted regulatory arbitrage. Many industry experts believe that the securities industry requires a uniform approach to short selling regulation, which can operate on a cross-border basis.\textsuperscript{245} This type of a regime could eradicate the negative effects of information asymmetry and regulatory arbitrage. These experts also propose that achieving internationally consistent standards of regulation could significantly improve investor confidence and reduce systemic risk in global capital markets.\textsuperscript{246} Considering the risks that information asymmetry and regulatory arbitrage may pose to the international securities industry, the organization's short position disclosure and reporting principles should embody the best-fitting rules, which provide the international securities industry with clarity and consistency in the area of short selling regulation.

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\item \textsuperscript{243} Deloitte Financial Group, supra note 232.
\item \textsuperscript{244} Id.
\item \textsuperscript{245} CESR Short Selling Measures, supra note 34.
\item \textsuperscript{246} Id.
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