Report

New in RegTech:

Tip of the Iceberg: Lurking below new rules on U.S. threshold disclosures is a much bigger global challenge

by:

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Welcome to this Global Investment Monitoring edition of the RegTech Report. This month we examine an important and taxing set of regulatory regimes, imposed by more than 100 countries around the world and applying generally to firms wherever domiciled. These regimes set investment limits and require threshold ownership disclosures, at levels commonly held by investment firms and other shareholders. As we'll cover, important regulatory changes are currently taking effect in this broad space, and that will continue as long as there are regulators.

The requirements oblige any shareholding entity to file a disclosure, or else refrain from further investment, when reaching a certain level of securities holdings. They separately cover long holdings in equity issuers (substantial shareholdings) as well as short positions (short selling disclosures), interests in commodity or financial derivatives (position limits), holdings in issuers involved in a takeover bid (dealing disclosures), and investments in restricted sectors (sensitive industries).

Meeting the challenge

The main burdens, for firms subject to these requirements, are keeping up with the changing regulations and maintaining operational efficiency. When firms aren't properly prepared, the requirements can drain compliance resources, generate large invoices from outside counsel, expose inadequate systems, encumber operations, and reduce employee morale. Ultimately, a firm's competitiveness is negatively affected.

Moreover, the regulator fines are frequent, ranging (in USD equivalent) from a few thousand USD to more than a million USD in more extreme cases. And typically the sanctions are publicly announced.

And yet, these requirements sometimes sit low in the pecking order of compliance department priorities. Why? Perhaps because violations rarely generate bold-face headlines from the financial press, like insider trading or market manipulation. Perhaps because the multitude of regulators and rule nuances tend to create a nagging itch or pest for firms: no single event enough to trigger an executive-level crisis meeting or major budget reallocation — and yet ultimately adding up to a significant drain on firm resources. Pick your metaphor: a school of piranhas, a swarm of bees, death by a thousand cuts.

For firms with interests on multiple markets, successfully meeting the challenge requires, at the very least, dedicated regulatory experts, robust monitoring systems and automated scraping of regulatory reference data. All in a continuing effort to keep up with frequent regulatory changes, properly calculate holdings and produce disclosures if required.

Let's examine what each of these regulatory frameworks entails, including some recent rule changes set to impact firms.

Major shareholding disclosures

Policy rationale: Transparency for existing shareholders (and the public), when other investors build large voting stakes.

Abstract

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Substantial shareholding. Stake-building. Shareholder disclosure. Threshold disclosure. For Americans, yet another term is used: beneficial ownership. Whatever jargon you prefer, it points to the requirement that any entity or individual must submit to the local regulator a notification, usually made public, once that party reaches a certain percentage of ownership in an issuer domiciled or listed in that local market. The initial threshold is often 5% of an issuer's outstanding voting capital, but can be as low as 3% or even lower, depending on the local regulations.

Challenges

The requirements are complex. Each jurisdiction sets forth rules on how to calculate holdings, addressing variables like the types of securities includable, inclusion of non-voting capital, any delta adjustment for options, treatment of index holdings or ETFs, and aggregation of holdings across affiliates or funds managed.

Each regulator also has its own view of the relevant issuers: those domiciled in its territory, listed on local markets, inclusion of private issuers, or some combination.

Moreover, the strict filing deadlines (varying between one and six days usually, but there are outliers), mandated notification templates, and methods of submission vary country-by-country.

Thus for a portfolio of holdings in 20 different markets, the vast, detailed requirements of 20 different regimes apply. And regulatory changes occur frequently, whether based on policy reviews, macroeconomic events, analysis of data gathered from filings, or advances in technology and automation.

This all must be understood from a regulatory perspective, and then implemented operationally, with pinpoint accuracy or else sanctions can be imposed for misreporting. And that's without considering the additional regimes for short positions, takeover holdings and more (also covered in this edition).

New U.S. requirements

In the U.S. some of the SEC's stricter requirements go into effect in less than two weeks (as we have detailed here). The rules apply to anyone in the world with a more than 5% voting interest in any issuer of U.S. exchange listed or publicly traded securities. Starting on September 30th, filing deadlines will tighten. In submitting their Schedule 13Gs, some filers ("Passive Investors") will see their deadlines reduced from 10 days to 5 business days, while many others ("Qualified Institutional Investors" and "Exempt Investors") who currently benefit from an annual deadline (the "Valentine's Day" filing, due 45 days after the end of the year) will henceforth need to submit their 13Gs on a quarterly basis.

Under these shorter deadlines, firms as always will need to consider what category of filer they belong in, whether they're filing an initial form (13G) or else an amendment (13G/A), additional filing thresholds (such as 1% swings, other events deemed "material", exceeding 10% and subsequent 5% swings) and other factors. The new rules also impact the filing of Schedule 13D, a longer form with tighter deadlines (often two business days) for those who don't qualify as 13G filers.

Taking action

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The solution is essentially twofold: regulatory expertise and operational readiness. Budgeting should include in-house regulatory experts, technology and compliance vendors with deep regulatory expertise, and local counsel (particularly for markets that offer insufficient regulatory guidance). There are also a small number of regulatory content vendors that specialize in threshold shareholder reporting. These subscription-based providers (such as the widely-used Aosphere) source the legal information from practicing attorneys worldwide, and package it into convenient, detailed reports about each jurisdiction.

From an operational standpoint – especially for firms frequently filing in multiple jurisdictions – automated monitoring and scraping of regulatory reference data is essential. Preparedness is also vital, well before approaching disclosure thresholds. A plan for sourcing issuer outstanding shares data, for example, is needed (for correctly calculating the percentage held in those issuers). Regarding the filing process, consult in advance the local filing portals, many of which require firms to register and receive approval before making filings. Filers should also ensure they source the correct local filing forms, and preferably automate the pre-population of those forms (using their holdings data) if possible.

"Valentine's Day will lose some of its enamoredness, yielding its status as the annual date for eligible 13G filers, to take a lesser place as one of four quarterly filing deadlines."

Greg Hotaling, Traders Magazine, "Reg 13D-G Compliance: the SEC 'Modernizes' Large Shareholder Reporting"

Short selling disclosures

Policy rationale: Information for regulators who monitor the threat of a steep downturn in markets.

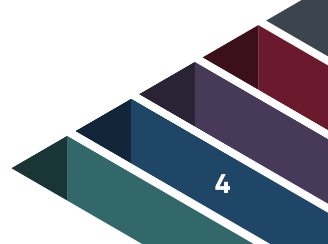
Abstract

Threshold disclosure requirements for taking short positions exist in about 35 countries, including the US, Japan and every EU country. They are not to be confused with the regulation of short sale transactions or orders (such as 'uptick' rules), which is even more common globally but often handled by brokers.

Challenges

For threshold short sale reporting, investment firms conduct largely the same type of analysis as for long holdings. That is, the relevant asset types to include, the relevant issuers, the calculation requirements for various types of derivatives, aggregation of their affiliates' holdings, how to complete and submit the filing form, and more. Again here, all of these aspects need to be addressed with precision in order to stay clear of regulatory sanctions.

The filing deadlines tend to be very tight. In the EU, a short position in any listed issuer, amounting to at least 0.1% of issuer outstanding shares, must be disclosed to the issuer's local regulator by 3:30pm the next trading day. The UK imposes the same deadline, but provided some relief for filers in February when it raised the triggering threshold from 0.1% to 0.2%. Meanwhile Japan, which also sets its threshold at 0.2%, imposes a deadline of two trading days.



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New U.S. requirements

In the US, a new regime that applies to institutional investment managers takes effect on 2 January 2025. Exigencies such as the data required in the new filing form have caused firms to scramble for efficient solutions. Under the relevant new Rule 13f-2, while Form SHO is required to be filed only monthly (14 days after the end of the month), it must provide information on daily activity affecting short positions.

Moreover, for short positions taken in reporting issuers under Rule 13f-2, the threshold triggering a filing ($10 million position value or else 2.5% of issuer outstanding) is based on a monthly average gross short position, rather than simply a day-end short position as required by most other such regimes around the world. Meanwhile disclosure when shorting non-reporting companies is required when reaching a $500,000 position value as of the end of any trading day.

Further complicating compliance efforts (and frustratingly, for institutional firms accustomed to relying on the SEC-published "13-F List" of eligible securities for their quarterly long reporting obligations), the SEC does not publish a "Form SHO List" of in-scope securities for these short reporting purposes. Instead, firms must ensure that any of their holdings falling within the scope of the SEC's new regime — including derivatives, or from non-reporting issuers, or OTC-traded — are captured by their compliance processes.

Taking action

The advisable approach here, globally, is no different than for major shareholding: dedicated regulatory resources, and operational efficiency including automation where possible. As for Rule 13f-2, firms have been undertaking significant efforts to implement new workflows and augment their automated processes, in preparation for the upcoming go-live date of 2 January 2025. There's still time to do so, but that time is closing.

"Given past market events, it's important for the Commission and the public to know more about short sale activity in the equity markets, especially in times of stress or volatility."

Gary Gensler, SEC Chair

Takeover panel disclosures

Policy rationale: Transparency, in the public bid process and for existing shareholders contemplating the takeover offer.

Abstract

Also called "dealing disclosures", these filings are required when investing a threshold amount in an issuer that is party to a public takeover bid. The initial filing threshold ranges from 1% of issuer outstanding shares (as seen in the UK, Ireland and Spain) to 5% (e.g. Australia, Hong Kong, Singapore). These regimes also commonly require that any subsequent "dealings" (transactions in those securities) be disclosed every time they happen.

Challenges

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Close to 20 regulators around the world impose these obligations and, like the other frameworks we describe in this edition, they apply to shareholders no matter where situated. Moreover, the filing deadlines tend to be very tight, often the next business day after the threshold is reached (as seen in the UK, Ireland, France, Switzerland, Hong Kong, Singapore, and Australia among other places).

Taking action

The quick deadlines and often low filing thresholds make it crucial that firms, investing in any of these markets, always know which issuers are involved in a public takeover bid. (Holdings in either the acquiror or the target company can be notifiable, depending on the jurisdiction.) Fortunately, most of the regulators provide a digitally scrapable, updated list of relevant issuers for that purpose (for example the online Disclosure Table issued by the UK Takeover Panel, or the downloadable .xls file Tableau OPA published by the AMF in France). But in a few jurisdictions, this information can be harder to find. In these cases, investing firms should instead turn to local public announcements about takeover proceedings, and consider those relevant issuers accordingly for threshold disclosure purposes.

"Once the terms of a draft public offer have been announced (i.e. the start of the pre-offer period), strict rules apply to trading in the securities concerned. Transparency procedures are strengthened for offers involving the securities of the target company and, where applicable, those of the bidder. "

Autorité des Marchés Financiers (AMF), "Reporting my transactions during a public offer period"

Sensitive industries limits

Policy rationale: The strategic protection of industries that are vital to the national economy or security.

Abstract

Sensitive industries rules are ownership limits, or in many cases disclosure or pre-approval requirements, when investing in sectors that a country deems vital to its national interests. Most countries have them. Transport, communications, utilities, defense, mining and media are common targets for these restrictions. The investment thresholds range widely: from a complete prohibition on investment, to 10%, 15% and higher levels of ownership in the issuer.

Challenges

Perhaps the most inscrutable of threshold investment rules, sensitive industries restrictions are usually set forth in statutes, with comparatively little published guidance. And any such advice might come not from a financial regulator, but from a government agency less familiar with the nuances of relevant securities, calculations, aggregation of affiliate holdings, and so on. When lacking such information, a cautious and conservative view of the rules is warranted.

Many additional limits or disclosure thresholds, often found in a separate comprehensive regime such as Australia's Foreign Acquisitions and Takeovers Act, apply exclusively to foreign investors. Also commonly found are cumulative limits, usually set at higher levels, restricting the amount of all shareholders' total investments in a relevant issuer. When investing on EU or UK markets, be aware of the prudential assessment regime, which requires pre-approval for threshold positions (starting at 10%) in a broad range of regulated entities including banks, insurers and investment firms.

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A recurring challenge is understanding what industry any given issuer occupies. Unfortunately there is no universal categorization of issuers and industries agreed upon by the world's regulators, despite some helpful taxonomies such as GICS and NAICS. And instances of cross-ownership can further muddy the waters about what industry a particular issuer occupies.

Taking action

So how to overcome these hurdles? As always it starts with access to regulatory expertise: dedicated in-house resources, compliance vendors with regulatory knowledge, and prudent retention of legal counsel when needed. The next step is the implementation of compliance processes, and automated monitoring if feasible, that reflect the thresholds and take a cautious view of any grey areas.

Essentially, the compliance challenge can be viewed much the same as for other types of position disclosures — but with a trickier regulatory component that may justify leaving more headroom when approaching threshold limits.

"To achieve additional peace of mind, in some circumstances investors may choose to make a voluntary notification to gain some reassurance that a transaction is not considered contrary to the national interest."

Rouse Lawyers, "A Guide to the Foreign Acquisitions and Takeovers Act 1975"

Position limits

Policy rationales:

1. Managing the responsible allocation of finite commodity resources.

2. Discouraging large price swings, for certain derivative contracts otherwise subject to destabilizing volatility."

Abstract

Varied position limits apply to many thousands of individual derivative listings, often futures contracts as well as options on futures. While traditionally they were intended for contracts with underlying commodities like agricultural products, metals and energy, today they also cover a variety of financial derivatives such as interest rate and index futures. They generally apply to any position holder no matter where domiciled, but often provide an important exemption for hedging practices (hence the more precise term sometimes used, "speculative position limits").

Challenges

Sourcing the rules and threshold limits – usually denominated as a fixed number of contracts or underlying commodity units (bushels, megawatt hours, etc.) — is a complex, multi-pronged task. Because potentially hundreds of individual products listed on any given exchange are each assigned their own limit, automated scraping of the information is essential. And while exchange venues commonly administer and publish limits at their discretion, regulators often get involved as well, issuing and enforcing limits linked to underlying commodities deemed vital to their territories. In sum, both operational and regulatory expertise is needed, just to keep up with the limit levels.

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But there's much more to tackle. Some limits are represented as a percentage of a contract's open interest, which changes daily. Perhaps most challengingly, position limits apply only during certain variable calendar periods, the "spot effective period" which can last just a few days or up to several months, and which differs for each listed product. Many limits are also staggered, decreasing as a contract approaches maturity. Holdings calculations are also critical of course, and must accurately reflect the relevant exchange or jurisdictional rules: aggregation of similar contracts, "contract ratio" adjustments, netting requirements, "diminishing balance" calculations, and more.

Taking action

For position holders trading more than just a few derivative contracts, a robust monitoring platform is therefore essential. Experienced compliance personnel — particularly those familiar with the rather specialized world of futures trading — are also important for understanding calculation requirements and tracking rule changes. These rule changes spring not just from the exchanges but also from regulators. The UK's FCA, for example, is currently preparing to revamp its position limit regime, aiming to create stricter requirements for a narrower set of contracts. (Meanwhile, for colorful accounts of how the US and EU regulatory frameworks came into being, see our previously posted articles Texas Outlaws and Born in the USA.)

"The proposed regime builds on changes we have already made to strengthen commodity derivative markets and supports our aim to strengthen the UK's position in global wholesale markets, a key priority in our 3-year strategy."

> *FCA, "CP23/27: Reforming the commodity derivatives regulatory framework"*

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